S. Hrg. 98-718

1983–84 MISCELLANEOUS TAX BILLS, VIII: S. 499, S. 831, S. 842, S. 1231, S. 1807 and S. 1914

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 499, S. 831, S. 842, S. 1231, S. 1807 and S. 1914

OCTOBER 28, 1983

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
28-040 O WASHINGTON : 1984

5361 31

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MISCELLANEOUS TAX BILLS, VIII: S. 499, S. 831, S. 842, S. 1231, S. 1807, AND S. 1914

FRIDAY, OCTOBER 28, 1983

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:25 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood and Boren.

Also present: Senators Weicker, D'Amato, Specter, Levin, and Congressman Eckart.

[The press release announcing the hearing, background material and texts of S. 499, S. 831, S. 842, S. 1231, S. 1807, and S. 1914, and prepared statements of Senators Boren and Durenberger follow:]

[Press Release No. 83-187]

FINANCE COMMITTEE SETS HEARING ON SIX MISCELLANEOUS TAX BILLS

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management, announced today that a hearing will be held on Friday, October 28, 1983 on six miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The following legislative proposals will be considered:

S. 499: Introduced by Senator D'Amato for himself and others. S. 499 would require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program.

S. 831: Introduced by Senator Specter. S. 831 would modify the tax treatment of transactions in which a homeowner sells his or her principal residence while retaining a life estate. The bill would treat such transactions as sales for purposes of the purchaser's depreciation allowances and the one-time capital gains exclusion for homeowners over age 55.

S. 842: Introduced by Senator Weicker for himself and others. S. 842 would provide tax incentives for the issuance of small business participating debentures.

S. 1231: Introduced by Senator Boren for himself and others. S. 1231 would exempt certain piggyback trailers and semitrailers from the tax on motor vehicles.

S. 1807: Introduced by Senator Percy for himself and Senator Dixon. S. 1807 would clarify the taxation of certain income derived from agricultural commodities not grown in the United States in commercially marketable quantities.

S. 1914: Introduced by Senator Specter. S. 1914 would facilitate home equity conversions through sale-leaseback transactions.

DESCRIPTION OF TAX BILLS (S. 499, S. 831, S. 842, S. 1231, S. 1807, AND S. 1914)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON OCTOBER 28, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on October 28, 1983, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are six bills scheduled for the hearing. Two of the bills (S. 831 and 1914) relate to the tax treatment of sales of interests in principal residences. S. 499 would provide that Federal guarantees provided by the Small Business Administration under its guaranteed debenture and pollution control programs could be used in conjunction with tax-exempt financing. S. 842 would provide special tax rules for small business participating debentures. S. 1231 would exempt certain piggyback trailers and semitrailers from the excise tax on heavy trucks and trailers. S. 1807 would exclude dividends attributable to certain foreign agricultural commodity income from taxation under the anti-tax haven provisions.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of provisions, and effective dates.

Congress of the United States
JOINT COMMITTEE ON TAXATION
Washington, D.C. 20515

ERRATA SHEET FOR JCS-51-83

October 27, 1983

(1) On page 13, the last sentence of the second paragraph under the heading **Depreciation** should read as follows:

"The anti-churning rule would apply, for example, if an investor-lessor entered into a sale-leaseback of property owned in 1980 by the seller-lessee."

(2) On page 16, the paragraph under the heading **Business use of principal residence rented under qualified sale-leaseback transaction**, should read as follows:

"Under the bill, rent paid by a seller-lessee under a lease constituting part of a qualified sale-leaseback transaction would not be subject to the business expense limitations imposed on persons making a business use of a residence."

I. SUMMARY

1. S. 499 — Senators D'Amato, Roth, and Others

Requirement That Certain Small Business Administration Guarantees Be Available in Connection With Tax-exempt Bonds

Under present law, the Small Business Administration (SBA) is authorized to guarantee debentures issued by State and local development companies to finance up to 50 percent of qualified small business projects. The SBA is further authorized to guarantee payments made by eligible small businesses in connection with governmentally mandated pollution control devices.

The statutes authorizing the guaranteed debenture and pollution control guarantee programs allow the guarantees to be made in connection with tax-exempt financing (thereby providing an effective guarantee for the tax-exempt bonds). However, the current practice of the SBA is to avoid participation in projects involving tax-exempt financing.

The bill would prohibit the SBA from declining to participate in projects, under the guaranteed debenture and pollution control programs, because of the presence of tax-exempt financing. The bill would further provide that it is the declared policy of Congress that the guarantee of payments for a pollution control facility would not cause the interest on tax-exempt bonds used to finance the facilities to become taxable.

2. S. 831 — Senator Specter

Tax Treatment of Sale of Principal Residences With Retention of Life Estate

and

S. 1914 — Senator Specter

Tax Treatment of Sale-leasebacks of Principal Residences

Under present law, whether a homeowner has engaged in a sale-leaseback of his principal residence which will be respected for tax purposes is largely a question of fact. If the transaction is so respected, the seller will be treated as having sold his principal residence, and the purchaser may be entitled to depreciate the property. S. 1914 would provide safe harbor rules for determining whether a valid sale-leaseback of a principal residence has occurred. It also would clarify the treatment of such a transaction under various provisions of the Code.

Also under present law, the purchaser of a remainder interest in property is not entitled to take depreciation deductions with respect to the property. S. 831 would allow the purchaser of a remainder interest following a life estate in a principal residence to depreciate the property. It also would allow the sale of such a remainder interest in a principal residence to qualify for the $125,000 exclusion described in Code section 121 (if the other requirements of that section are met).

3. S. 842—Senators Weicker, Heinz, Boren, Baucus, Durenberger, and Others

Tax Treatment of Small Business Participating Debentures

The bill would provide tax incentives for the creation of, and investment in, a new type of security, the Small Business Participating Debenture (SBPD). A portion of the annual return on these debentures would be measured by reference to the earnings of the issuer. This portion would be treated as long-term capital gain by the investor and would be deductible as interest by the business. If an individual investor incurs a loss with respect to an SBPD, the loss would generally be treated as an ordinary loss (rather than a capital loss).

4. S. 1231—Senators Boren, Matsunaga, Mitchell, Symms, Baucus, Wallop, and Pryer

Exemption From Excise Tax on Heavy Trucks and Trailers for Certain Piggyback Trailers and Semitrailers

Present law (as amended by the Highway Revenue Act of 1982) imposes a 12-percent excise tax, effective April 1, 1983 through September 30, 1988, on the first retail sale of heavy trucks and trailers. Rail trailers designed for use both as a highway vehicle and as a railroad car are exempt from the tax. Piggyback trailers, which ride only on the highway but are equipped to be lifted onto flatcars in order to travel by rail, are not exempt from the excise tax.

The bill would exempt piggyback trailers and semitrailers from the tax on heavy trucks, trucks and trailers. The exemption would be effective as if included in the Highway Revenue Act of 1982.

5. S. 1807—Senators Percy and Dixon

Exclusion of Certain Foreign Agricultural Commodity Income as Foreign Personal Holding Company Income

Under present law, dividends received by a foreign corporation which is controlled by U.S. shareholders are considered foreign personal holding company income and as such may be taxable to the U.S. shareholders. The fact that the underlying income of the payor corporation is not taxable to the U.S. shareholders does not relieve the dividend from being foreign personal holding company income.

Under the bill, dividends received by a controlled foreign corporation will not be considered foreign personal holding company income for purposes of the anti-tax haven provisions (Code secs. 951-64, often referred to as subpart F) if the following conditions are met: (1) the dividends are paid out of earnings and profits of another foreign corporation for a taxable year in which at least 70 percent of the payor corporation's gross income (other than subpart F income) is from the purchase or sale of agricultural commodities not grown in the United States in commercially marketable quantities, (2) the corporations are members of the same affiliated group and a U.S. shareholder owns more than 50 percent of the stock of both, and (3) certain five-year active business and length of existence requirements are met.

II. DESCRIPTION OF THE BILLS

1. S. 499 — Senators D'Amato, Roth, and others

Requirement That Certain Small Business Administration Guarantees Be Available in Connection With Tax-exempt Bonds

Present Law

Federal income tax rules

Tax exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services, including schools, roads, water, sewer, and general improvement projects and the financing of public debt. Additionally, State and local governments may provide tax-exempt financing for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations.

Industrial development bonds

Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of the proceeds of which are to be used in any trade or business carried on by a non-exempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business.

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the IDBs are used for specific exempt functions. These include IDBs the proceeds of which are used to provide air or water pollution control facilities (sec. 103(b)(4)(F)). Interest on IDBs is also tax-exempt if the bond proceeds are used to finance (1) projects for low-income multifamily rental housing, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass community facilities, or parking facilities, (5) sewage and solid waste disposal facilities, (6) facilities for the local furnishing of electricity or gas, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, (9) qualified mass commuting vehicles, (10) local district heating or cooling facilities, or (11) land acquired or developed as the site for an industrial park.

Present law also provides a tax exemption for interest on certain "small issue" IDBs the proceeds of which are used for the acquisition, construction, or improvement of certain land or depreciable property. The exemption applies to issues of $1 million or less without regard to related capital expenditures. Alternatively, the amount of the issue, together with certain related capital expenditures over a 6-year period, must not exceed $10,000,000.

Treasury regulations provide that pollution control devices eligible for tax-exempt financing include property to be used, in whole or in part, to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing pollutants, contaminants, wastes, or heat. Treas. Reg. sec. 1.103-8(g)(2)(ii).

Small Business Investment Act

SBA-guaranteed debentures

Under the Small Business Development Center Act of 1980 (P.L. 96-302),[1] the Small Business Administration (SBA) is authorized to guarantee debentures issued by State or local certified development companies (CDCs) to finance the purchase of land, plant and equipment (i.e. fixed assets) for qualifying small business concerns. The debentures are to be used to make loans for up to 50 percent of the costs of a project, to a maximum of $500,000. The program is designed so that the SBA-guaranteed loan may be leveraged in order to encourage the private sector to make long-term capital available to the project.

The statute enacting the guaranteed debentures program provides that debentures guaranteed under the program may be subordinated to any other debenture, promissory note, or other debt or obligation issued by the State or local development company. The statute further provides that the full faith and credit of the United States is pledged to the payment of amounts guaranteed under the program.

SBA regulations provide that loans made with the proceeds of SBA-guaranteed debentures may be subordinated to repayment of tax-exempt obligations used to finance the same projects (thereby providing an indirect guarantee for the tax-exempt obligations).[2] However, proposed SBA regulations provide that the SBA will not participate in projects in which loans made with the proceeds of guaranteed debentures are subordinated to loans made with the proceeds of tax-exempt bonds.[3] This policy has been explained by the Administration as part of a general policy of discouraging Federally-guaranteed tax-exempt obligations.[4]

Pollution control guarantees

Under 1976 amendments to the Small Business Investment,[5] the SBA is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design, or installation of governmentally mandated pollution control facilities. The statute enacting this program provides specifically that, notwithstanding any contrary law, rule or regulation or fiscal policy, the guarantee authorized in the case of pollution control facilities or property may be issued when such property is acquired with the proceeds of tax-exempt industrial revenue bonds. The statute provides that any further such guarantee shall be a full faith and credit obligation of the United States.

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[1] Sec. 503 of the Small Business Investment Act of 1958 (15 U.S.C. sec. 697)

[2] 13 C.F.R. sec. 108.503-4(c).

[3] Proposed Regs., 13 C.F.R. sec. 108.503-4(c), Fed. Reg., March 7, 1983.

[4] See Committee on Small Business, Subcommittee on Urban and Rural Economic Development, Hearings on SBA's Economic Development Programs, testimony of Roger Mehle (Deputy Assistant Secretary of the Treasury), September 28, 1982.

[5] Sec. 404 of the Small Business Investment Act of 1958 (15 U.S.C. sec. 694-1).

The SBA announced in January, 1982, that it would not guarantee further pollution control projects financed with tax-exempt obligations. At the time of this amendment, all or virtually all SBA-guaranteed pollution control projects had been financed with tax-exempt obligations.

The Internal Revenue Service, in 1978, stated that the interest on pollution control IDBs issued for SBA-guaranteed projects is exempt from tax. Rev. Rul. 78-171, 1978-1 C.B. 29.

Precedents for Federal guarantees of tax-exempt bonds

The Public Debt Act of 1941[6] prohibits the Federal Government from issuing tax-exempt obligations. Since that time, the Federal Government has generally refrained from guaranteeing tax-exempt State or municipal bonds. However, in certain limited cases, Federal agencies may provide additional security for tax-exempt bonds through (1) guarantee of obligations which are used to secure tax-exempt bonds or (2) subordination of debts owned to the Federal Government to the tax-exempt bonds. In other cases, the law specifically prohibits the guarantee of tax-exempt obligations.

New York City loan guarantees—The New York City Financial Assistance Act of 1978 (Pub. L. 95-339) authorized the Treasury Department to guarantee payment of interest and principal on New York City indebtedness issued to certain public employee pension funds. The Act provided specifically that any guaranteed obligation would be treated as a taxable obligation with respect to interest accrued during the guarantee period. The Conference Report accompanying the Act[7] states that the conferees sought to avoid establishing a precedent for tax-exempt federally guaranteed obligations since obligations which combined a Federal guarantee and tax-exempt interest would be more desirable to investors than United States Treatury obligations (which are taxable) or other obligations issued by State or local governments (which are tax-exempt but not federally guaranteed).

Department of Agriculture (Farmers Home Administration)—The Farmers Home Administration (FmHA) guarantees loans for various agricultural purposes. The FmHA amended its regulations in 1982 to provide that the FmHA will not guarantee loans made with the proceeds of tax-exempt obligations.[8] Additionally, no FmHA loan may serve as collateral for a tax-exempt issue.

Housing and Urban Development—Section 11(b) of the Housing Act of 1937 provides a special tax exemption for obligations issued by State and local housing agencies in connection with low-income housing projects. The Act[9] prohibits the Department of Housing and Urban Development (HUD) from guaranteeing any tax-exempt obligation issued by a State or local agency. However, under certain circumstances, an issuer may pledge HUD loans or contributions (which are backed by the full faith and credit of the United States) as security for tax-exempt obligations.

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[6] 55 Stat. 7 (1941).

[7] H. Rep. No. 95-1369, accompanying H.R. 12426, 95th Cong., 2d Sess. (July 18, 1978).

[8] 7 C.F.R. sec. 1980.23.

[9] 42 U.S.C. sec. 1437c(g).

Mortgage insurance—The Department of Housing and Urban Development, Federal Housing Authority is authorized to insure mortgages on various properties, including certain owner-occupied housing, rental and cooperative housing, housing for moderate income and displaced families, housing for elderly persons, and hospitals and nursing homes.[10] These may include mortgages on properties constructed with tax-exempt financing. In these situations, FHA-insured mortgages may be pledged as security for tax-exempt bonds. Under certain circumstances, mortgages insured by the Veterans Administration (VA) may also serve as security for tax-exempt bonds.

Student loan bonds—The Department of Education guarantees repayment of certain student loan bonds. In certain cases, these guaranteed loans may be pledged as security for repayment of tax-exempt bonds.

FSLIC-and FDIC-guaranteed bonds—The Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) insure deposits to a maximum of $100,000 per depositor.[11] In certain issues of tax-exempt bonds, the issuing authority has deposited the bond proceeds in bank or savings and loan accounts insured by the FSLIC or FDIC, to be loaned to the user by the depository institution (loans-to-lenders programs). Because in the typical arrangement a trustee for the bondholders holds a certificate of deposit in an FDIC or FSLIC insured institution, the repayment of the bonds is effectively guaranteed to the extent of $100,000 per depositor.[12]

Energy program guarantees—Under certain energy production or conservation programs, the Federal Government may guarantee the payment of principal or interest on IDBs used to finance qualified hydroelectric generating facilities or qualified steam-generating or alcohol-producing facilities. The Internal Revenue Code (sec. 103(h)) eliminates the tax exemption for bonds guaranteed under these programs. Additionally, the tax exemption is eliminated when principal or interest on the bonds is to be paid with funds provided by Federal, State or local governments under an energy production or conservation program.

Issues

The principal issue is whether projects financed with tax-exempt bonds should be entitled to receive effective Federal guarantees under the SBA-guaranteed debenture and pollution control programs. Related issues include:

First, do Federal guarantees for tax-exempt bonds have a detrimental effect on the market for Federal securities?

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[10] National Housing Act of 1934, 12 U.S.C. sec. 1707 et. seq.

[11] See 12 U.S.C. sec. 1724(b) and 12 C.F.R. secs. 564.2(c) and 564.8 (FSLIC); 12 U.S.C. sec. 1817(i) and 12 C.F.R. secs. 331(b) and 330.8(b) (FDIC).

[12] S. 1061, introduced by Senators Dole and Symms, would eliminate the tax exemption for any obligation which was part of an issue a significant portion of the principal or interest on which is to be insured (directly or indirectly) by a Federal deposit insurance agency as a result of the investment of the proceeds in deposits or accounts of a federally insured financial institution. The bill would generally be effective for obligations issued after April 15, 1983.

Second, do such guarantees increase the volume of tax-exempt bonds and, therefore, have a detrimental effect on State and local borrowing for traditional public purposes?

Third, how can guarantees of small business projects be distinguished from other Federal guarantees?

Explanation of the Bill

SBA-guaranteed debentures

The bill would amend the Small Business Investment Act to prohibit the Administration from declining to guarantee debentures for a project because the other sources of financing for the project include or are collateralized by tax-exempt bonds (Code sec. 103(b)). Additionally, the bill would provide that no Federal agency or official (including the Administration) may restrict the use of guaranteed debentures in connection with tax-exempt obligations if the project otherwise complies with the requirements of the program. The bill would further provide that, where the financing for a project includes or is collateralized by tax-exempt obligations, SBA-guaranteed debentures (or loans made with the proceeds of these debentures) shall be subordinated to the tax-exempt obligations.

Pollution control guarantees

The bill would amend the Small Business Investment Act to provide that, notwithstanding any contrary law, rule, or regulation or fiscal policy and subject only to the existence of qualified guarantee applications and available statutory authority, the Administrartion may not decline to issue guarantees of pollution control facilities or property. Thus, under the bill, the Administration would be prohibited from denying a guarantee application because of the presence of tax-exempt financing. The bill would further provide that it is the declared policy of Congress that the guarantee of payments for pollution control facilities would not cause the interest on tax-exempt obligations used to finance the facilities to become taxable.

Prior Congressional Action

The bill (S. 499) has been reported favorably by the Committee on Small Business and was subsequently referred to the Committee on Finance. S. Rep. 98-22, 98th Cong., 1st Sess. (March 11, 1983).[13]

Effective Date

The bill would be effective upon the date of enactment.

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[13] The House Committee on Small Business has reported a similar measure, in H.R. 3020. H. Rep. No. 98-182, 98th Cong., 1st Sess. (May 16, 1983).

2. S. 831 — Senator Specter

Tax Treatment of Principal Residences With Retention of Life Estate

and

S. 1914 — Senator Specter

Tax Treatment of Sale-leasebacks of Principal Residences

(Home Equity Conversion Act of 1983)

Present Law

In general

A sale-leaseback is any transaction in which the owner of property sells the property and then leases the property back from the purchaser. In general, if a valid sale-leaseback with respect to property occurs, the purchaser-lessor is entitled to depreciate its basis in the property, and the seller-lessee, if it uses the property in a trade or business or holds the property for the production of income, can deduct rental payments. The purchaser-lessor generally can also deduct any property taxes and any interest paid or accrued on any indebtedness incurred to purchase the property.

Under present law, a homeowner may make a sale-leaseback of his principal residence which will be respected for tax purposes. In a valid sale-leaseback, the sale and the leaseback are generally treated as separate transactions. Thus, in the case of a valid sale leaseback of a principal residence, the seller may elect to exclude from gross income up to $125,000 in gain on the sale under the provisions of section 121 if the requirements of that provision are met. Furthermore, the purchaser-lessor of the property would be entitled to depreciate the property and to deduct such expenses in connection with the ownership or operation of the property as may be allowable as ordinary and necessary business expenses (or expenses paid or incurred for the production of income). However, if the sale-leaseback transaction were not entered into by the purchaser-lessor for profit, depreciation deductions and deductions for such expenses would be limited.

Whether a sale-leaseback transaction will be respected for tax purposes is largely a question of fact. Some of the relevant factors include whether (1) the sale price equals the property's fair market value, (2) a reasonable rate of interest is charged on any purchase money indebtedness, (3) the rent equals fair rental value for the property for the term of the lease and any renewals, (4) the benefits and burdens of ownership fall on the purchaser-lessor (and not on the seller-lessee as, for example, with a repurchase option at a fixed price), (5) the parties intend a sale-leaseback (as opposed to a mere purchase option, financing device or tax avoidance scheme), and (6) the transaction is structured as a sale-leaseback (as opposed to a sale of a remainder interest only or some other transaction).

A sale at less than fair market value, or a lease at less than fair rental value, will not necessarily invalidate a sale-leaseback transaction for tax purposes. However, such a discounted purchase price or discounted rentals may be treated as a payment to the benefited party.[1] Thus, if a homeowner engages in a sale-leaseback with respect to his principal residence and discounts the sale price in return for a lower than fair rental value rent, the homeowner could be deemed to have received a fair market value sale price and to have prepaid the difference between the discounted value of a fair rent on the property and the discounted value of the actual rent to be paid on the property.

Sale of a remainder

A transaction with an economic result similar to that of a sale-leaseback is a sale by a property owner of a remainder interest in the property. In such a transaction, the seller may retain a life estate in the property (or an estate for a term of years). In the case of a life estate, the owner of the remainder interest has the right to possess the property on the termination of the measuring life or lives. In general, in the case of a lease, the lessor has the right to possess the property at the end of the lease term.

In the case of the purchase of a remainder interest, the purchaser is not entitled to depreciate the property. Rather, the entire depreciable interest is deemed to remain with the holder of the life estate (section 167(h)). In addition, it has been held that the remainder interest itself cannot be depreciated until the prior estate terminates. *Geneva Drive-In Theater, Inc. v. Commissioner,* 67 T.C. 764 (1977), *aff'd per curiam,* 622 F. 2d 995 (9th Cir. 1980). However, in general, interest paid or incurred by the purchaser of a remainder interest with respect to any acquisition indebtedness would be deductible, subject to other limitations of the Code which may apply. Because the seller of the remainder interest following a life estate retains the right of possession during his lifetime, generally no rental payments would be paid to the holder of the remainder interest.

Exclusion from gross income of sale proceeds on sale of principal residence by elderly seller

Under present law, a taxpayer may elect to exclude from gross income up to $125,000[2] of any gain realized on the sale or exchange of his principal residence (section 121). That election is available to the taxpayer only if the taxpayer has attained the age of 55 before the date of the sale or exchange and only if the property sold was owned and used by the taxpayer as his principal residence for periods aggregating at least three years during a five year period ending on the date of the sale or exchange. In general, the election is available only once to a taxpayer.[3] In the case of stock in a cooperative housing corporation, the holding and use requirements apply to the taxpayer's stock ownership in the corporation and right to possess a particular apartment in the building.

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[1] See and compare, *Alstores Realty Corp. v. Commissoner,* 46 T.C. 363 (1966), acq. 1967-2 C.B. 1, and *Giberson v. Commissioner,* 44 T.C.M. 154 (1982), with Rev. Rul. 77-413, 1977-2 C.B. 298.

[2] $62,500 in the case of a married individual filing a separate return.

The sale by a taxpayer of his principal residence in a valid sale-leaseback transaction will generally qualify for treatment under section 121. However, the sale of the remainder interest in a principal residence may not.

Depreciation

Property which is recovery property may be depreciated under one of the accelerated cost recovery (ACRS) schedules contained in section 168. In general, recovery property is tangible depreciable property, whether new or used. Each item of recovery property under ACRS falls into one of five classes.[4] Depreciable property is any property used in a trade or business or held for the production of income which has a determinable limited useful life. Under ACRS, real property can be depreciated over a 15-year period by applying recovery percentages that approximate use of the 175-percent declining balance method in early years and the straight-line method in later years.

Anti-churning rules exclude property acquired after 1980 from the definition of recovery property if such property was owned by the taxpayer or a related person in 1980. Similarly, depreciable real property leased after 1980 to a person who owned the property in 1980 or a related person is not recovery property. The anti-churning rule would apply, for example, if an investor-lessor entered into a sale-leaseback in 1980.

Depreciable property that is not recovery property may be depreciated over its useful life (sec. 167). In most cases, the useful life of used real property exceeds 15 years (the recovery period under ACRS). Under section 167, the most accelerated depreciation method allowed for used residential rental property is the 125-percent declining balance method.

Activities not engaged in for profit

In general, unlimited deductions (other than for interest and taxes) are allowable only with respect to an activity which is engaged in for profit. If an individual or an S corporation engages in an activity not for profit, then no deductions (other than for interest and taxes) attributable to such activity are allowable in excess of a certain amount (sec. 183). That amount is the gross income attributable to such activity minus interest and taxes attributable to such activity. An activity is presumed to be engaged in for profit if gross income from such activity exceeds the deductions attributable to such activity during any two or more years during a five consecutive taxable year period ending with the current taxable year. The Tax Court has held that the purchase and leaseback of a principal residence in a sale-leaseback can be a transaction entered into for profit by the purchaser. *Langford* v. *Commissioner*, 42 T.C.M. 1160 (1981).

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[3] Elections with respect to sales or exchanges on or before July 26, 1978, are ignored.

[4] These classes are 3-year property, 5-year property, 10-year property, 15-year real property, and 15-year public utility property.

Installment sales

In general, the sale by a taxpayer of his principal residence may be reported as an installment sale. Subject to certain exceptions, a sale is an installment sale if at least one payment is to be received after the close of the taxable year in which the sale (or other the disposition) occurs. If a sale is an installment sale, the gain on the sale which is recognized in any taxable year is that proportion of the payments received in that taxable year which the gross profit on the sale (or other disposition) bears to the total contract price. Thus, under the installment sales method, gain on a sale or other disposition is recognized as payments on the sales price are received. However, while income recognition to the seller is deferred, the purchaser in such a transaction is generally entitled to commence depreciating the property immediately.

In general, the term "payment" under the installment sales provisions does not include receipt of an evidence of indebtedness of the purchaser, even if such obligation is guaranteed by a third party. However, payment generally does include receipt of an evidence of indebtedness of a person other than the purchaser. The installment sale rules can also apply to contingent payment sales. A contingent payment sale is any sale or other disposition of property in which the aggregate selling price cannot be determined at the close of the taxable year in which the sale or other disposition occurs. Under present law, if all or a portion of the purchase price consists of an annuity, it is possible (depending upon the terms of the individual annuity) that the annuity could be viewed as a payment to the extent of its fair market value in the year of receipt. If the purchaser is the issuer of the annuity, the transaction could be viewed as a sale for a contingent payment sale.

Business use of principal residence

In general, trade or business expenses are not allowable with respect to the business use by a taxpayer of his principal residence. Certain exceptions to this general rule apply, however. As one exception, if a portion of a principal residence is used exclusively as the principal place of business for any trade or business of the taxpayer on a regular basis, expenses allocable to that portion of the dwelling unit are allowable to the extent of the excess of the gross income derived from such use by the taxpayer for the taxable year over deductions allocable to such use which would otherwise be allowable under the Code. Another exception applies with respect to a taxpayer who rents a dwelling unit at a fair rental to any person for use as such person's principal residence pursuant to a shared equity financing agreement. For this purpose, a shared equity financing agreement means any agreement under which two or more persons acquire an undivided interest for more than 50 years in the entire dwelling unit and one of those persons is entitled to occupy the dwelling unit for use as a principal residence subject to an obligation to pay rent to one or more other persons holding an interest in the dwelling unit.

Explanation of the Bill

a. *S. 1914: Tax treatment of sale-leasebacks of principal residences*

In general

Under the bill, a safe harbor for homeowner sale-leasebacks would be established. A variety of tax benefits would accrue to the parties to a qualified sale-leaseback transaction. A qualified sale-leaseback transaction is a sale-leaseback which meets certain requirements. The seller-lessee must have attained the age of 55 before the date of the transaction. In addition, the seller-lessee must sell property which was owned and used by the seller-lessee as his principal residence at the time of the transaction and which had never been depreciable real property in his hands. The seller-lessee must retain occupancy rights in such property pursuant to a written lease requiring the payment of a fair rent. Finally, the purchaser-lessor must be a person contractually responsible for the risks and burdens of ownership [5] after the date of the transaction.

For this purpose, the term "occupancy rights" means the right to occupy the property for a term which equals or exceeds one-half the life expectancy of the seller-lessee (or the joint life expectancies of the seller-lessees in the case of jointly-held occupancy rights) at the date of the transaction. The right must be continually renewable by the seller-lessee (or the surviving spouse in the case of jointly held occupancy rights) and must terminate no later than the death of the seller-lessee (or the surviving spouse in the case of jointly-held occupancy rights). For this purpose a fair rental is any rent which is determined on the date of the sale-leaseback transaction and which equals or exceeds 80 percent of the appraised fair market rent for the term of the occupancy rights.

The bill's sale-leaseback safe harbor is not intended to create any inference as to the correct treatment of any transactions falling outside such safe harbor.

Depreciation

Under the bill, the purchaser-lessor in any qualified sale-leaseback transaction would be allowed any depreciation on the property as if he were the sole owner of the property.[6]

Exclusion from gross income and amount realized

For purposes of section 121, a sale or exchange would include the sale of a principal residence in a qualified sale-leaseback transaction. Thus, in such a case, the seller could elect to exclude from gross income $125,000 of gain from the sale or exchange.

In addition, new section 121A would be added to the Code. This provision would exclude from gross income of the seller the excess of the fair market value of any occupancy rights reserved or retained by the seller in a qualified sale-leaseback over the rent charged under the lease. Furthermore, none of such excess would be included under section 1001 as an amount realized on the sale.

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[5] While the bill refers to risks and burdens of ownership, it is intended that the purchaser-lessor must be entitled to the benefits of ownership as well.

[6] It is intended that the property involved in a qualified sale-leaseback transaction would be recovery property in all events.

In addition, new section 121A would exclude from the gross income of the purchaser any rent discount.

Application of installment sale provisions—receipt of annuity

The bill would provide a special rule for certain cases in which part or all of the consideration paid to the seller-lessee by the purchaser-lessor in a qualified sale-leaseback transaction is in the form of an annuity. In the case of an annuity purchased from a third party by the purchaser-lessor for the seller-lessee in a qualified sale-leaseback transaction, the cost to the purchaser of the annuity would be deemed to be the amount of the payment received by the seller. In addition, that amount would be deemed to be received by the seller in the year of the sale, even if payments on the annuity were deferred and contingent.

If the seller-lessee in connection with a qualified sale-leaseback transaction receives an annuity, the amount paid by the purchaser-lessor for the annuity would be treated as an investment by the seller-lessee in the annuity contract for purposes of section 72.

Transaction engaged in for profit

Any qualified sale-leaseback transaction would be presumed to be one engaged in for profit unless the Secretary of the Treasury establishes to the contrary. Thus, the purchaser-lessor would be allowed to deduct otherwise deductible expenditures without regard to the limitations applicable to transactions not entered into for profit.

Business use of principal residence rented under qualified sale-leaseback transaction

Under the bill, rent paid by a seller-lessee under lease constituting part of a qualified sale-leaseback transaction by the purchaser-lessor would not be subject to the business expense limitations imposed on persons making a business use of a residence.

Effective Date

The provisions of this bill would apply to sales after the date of enactment in taxable years ending after such date.

b. *S. 831: Tax treatment of sale of principal residences with retention of life estate*

Under the bill, Code section 121 would be amended to provide that the sale by a taxpayer of a remainder interest (following a life estate) in his principal residence would qualify for treatment under that provision.

In addition, any sale of a remainder interest qualifying under section 121 would also receive special treatment under the depreciation provisions of the Code. The purchaser of the remainder interest would be treated as the absolute owner of the property for depreciation purposes (including for accelerated cost recovery purposes).

Effective Date

The provisions of this bill would apply to sales or exchanges after the date of enactment in taxable years ending after such date.

3. S. 842—Senator Weicker, Heinz, Boren, Baucus, Durenberger, and Others

Tax Treatment of Small Business Participating Debentures

Present Law

Under present law, an investor who receives periodic distributions (i.e., interest) from a business with respect to a debt instrument is taxed at ordinary income rates on that income. Similarly, an investor who receives periodic distributions with respect to an investment in common or preferred stock (i.e., dividends) in the business is normally required to treat such income as ordinary income (to the extent that an exclusion or deduction for dividends received is not available).[1]

Further, in the case of an investor (other than a dealer), a loss on the worthlessness, sale, or other disposition of a debt instrument or share of preferred stock purchased for investment is ordinarily a capital loss. Similarly, a loss on the worthlessness, sale, or other disposition of a share of common stock is ordinarily a capital loss unless section 1244 applies. Under section 1244, an individual may treat losses on certain common stock issued by a small business as an ordinary loss (subject to certain limitations). This ordinary loss treatment under section 1244 is not available to an investor who invests in preferred stock or debt.

Under present law, a taxpayer may deduct interest paid or accrued on business indebtedness; however, a corporation is not entitled to deduct amounts paid as dividends on preferred or common stock.

Issues

The principal issue is whether tax incentives should be provided to encourage the issuance of, and the investment in, securities issued by small businesses which are characterized by participation in the current earnings of the business but not the underlying appreciation of the business. If so, a second issue is whether the types of incentives created by the bill are appropriate. A third issue is how a qualified small business should be defined.

Explanation of the Bill

In general

The bill would provide tax incentives for the creation of, and investment in, a new type of security, the Small Business Participating Debenture (SBPD). Under the bill, an SBPD could be issued only by a qualified small business and would be an instrument having characteristics of both debt and equity. A holder of an SBPD would treat interest payments received under the SBPD as ordinary income. Payments received as a share of the issuer's earnings would be treated as long-term capital gain. A loss incurred on the worthlessness, sale, or other disposition of an SBPD issued to an individual would generally be treated as if it were a loss on section 1244 stock. A small business issuing an SBPD would be permitted to treat all payments made under the SBPD as interest and, thus, would be allowed to deduct the amounts paid as shares of its earnings as interest (under sec. 163).

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[1] An individual is generally allowed an exclusion for up to $100 of dividends annually. Corporations are entitled to a dividends received deduction for 85 or 100 percent of the dividends received.

Definitions of SBPD and qualified small business

The bill defines an SBPD as a written debt instrument issued by a qualified small business which (1) is a general obligation of the business, (2) bears a stated rate of interest not less than the rate prescribed by the Secretary under section 483(c)(1)(B),[2] (3) has a fixed maturity, (4) grants no voting or conversion rights in the qualified small business to the purchaser, and (5) provides for the payment of a share of the total earnings of the issuer.

A qualified small business would be any domestic trade or business (whether or not incorporated) which (1) has equity capital not exceeding $10 million immediately before the SBPD is issued, and (2) has no securities outstanding which are subject to regulation by the Securities and Exchange Commission. Further, for a small business to be treated as a qualified small business, the face value of all the outstanding SBPDs issued by the business (including the SBPD being issued) must not exceed $1 million. For purposes of determining qualification as a qualified small business, the equity capital and outstanding SBPDs of all members of a controlled group would be taken into account. A controlled group would consist of all businesses under common control with the issuing corporation within the meaning of section 1563(a), except that a more-than-50-percent test would be applied rather than the 80-percent test. The same general principles would be applied to commonly controlled businesses which are not incorporated.

Tax treatment by the investor of income, gains, losses, etc., on the SBPD

Amounts received by a taxpayer (other than a taxpayer with a 10-percent equity interest in the business) as a share of the issuer's earnings on the SBPD would generally be treated as long-term capital gain. For the purpose of determining the tax treatment of any loss on the SBPD, the taxpayer would treat the loss as if it were on a loss on section 1244 stock. Thus, the taxpayer could be allowed an ordinary loss rather than a capital loss from the worthlessness or sale or exchange of the SBPD.

Tax treatment by the qualified small business of SBPD payments

Generally, both the amounts paid as interest and the amounts paid as a share of the issuer's earnings would be treated as interest and deductible under section 163 by the qualified small business which has issued the SBPD.

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[2] That rate is presently nine percent.

Effective Date

Generally, the provisions of the bill would apply to taxable years beginning after December 31, 1982, and to SBPDs acquired after the date of the enactment of the bill. However, the provisions of the bill would not apply to any SBPD issued before or during the calendar year 1983, if the proceeds of such SBPD are used to repay any loan of the issuing small business other than a loan with a stated rate of interest in excess of the prevailing rate of interest for businesses in the area where the business is located and which is secured by its inventory or accounts receivable.

4. S. 1231 — Senators Boren, Matsunaga, Mitchell, Symms, Baucus, Wallop, and Pryor

Exemption From Excise Tax on Heavy Trucks and Trailers for Certain Piggyback Trailers and Semitrailers

Present law

A 12-percent excise tax is imposed on the first retail sale of truck chassis and bodies, truck trailer and semitrailer chassis and bodies, and highway tractors used in combination with a trailer or semitrailer (including, in each case, related parts or accessories). Truck chassis and bodies are taxable only if suitable for use with a vehicle whose gross vehicle weight exceeds 33,000 pounds. Truck trailer and semitrailer chassis and bodies are taxable only if suitable for use with a trailer or semitrailer whose gross vehicle weight exceeds 26,000 pounds. A 12-percent retail tax also applies to the installation of nonreplacement parts and accessories on a taxable article, if installation occurs within 6 months after the article was placed in service and the aggregate value of installed parts (including instalaton costs) exceeds $200 (Code sec. 4051).

Certain articles, including chassis and bodies (and related parts of accessories) of trailers and semitrailers designed for use both as a highway vehicle and as a railroad car (rail trailers), are exempt from the excise tax. In addition to their capacity to ride on the highways, the exempt rail trailers are equipped with train wheels which enable them to ride on rails. Piggyback trailers and semitrailers, which ride only on the highway, but are equipped to be lifted onto flatcars in order to travel by rail are not specifically exempt from the excise tax because they are not designed for use as a railroad car (Code sec. 4053).

The Highway Revenue Act of 1982 (the Act) converted the prior law 10-percent manufacturers excise tax on trucks and trailers into the 12-percent retail excise tax of present law, effective April 1, 1983. In addition, the Act provided the present exemption for rail trailers, effective January 7, 1983, and allowed refunds of the 10-percent tax to manufacturers for rail trailers purchased by the ultimate consumer after December 2, 1982.

The retail excise tax on trucks and trailers is scheduled to expire on October 1, 1988.

Issues

The primary issue is whether piggyback trailers are more properly treated as highway trailers, which are subject to the 12-percent retail excise tax, or as rail trailers, which are exempt from the tax. A second issue, relating to the yield and administration of the tax, is whether the additional cost of equipping a trailer to be a piggyback trailer is large or small relative to the value of excise tax exemption. A third issue is whether any exemption for piggyback trailers should be effective retrospectively (to the effective date of the present exemption for rail trailers) or prospectively.

Explanation of the Bill

The bill would exempt piggyback trailers and semitrailers (including parts or accessories) from the 12-percent retail excise tax on heavy trucks and trailers. A piggyback trailer or semitrailer would include any trailer or semitrailer which is designed for use principally in connection with trailer-on-flatcar rail service. The seller of the trailer or semitrailer would be required to certify that it would be used principally in connection with trailer-on-flatcar service, or incorporated into an article which will be used in this manner.

Effective Date

The bill would be effective as if included in that provision of the Highway Revenue Act of 1982 which exempted rail trailers. Thus, the exemption would apply to the 12-percent retail excise tax from its effective date of April 1, 1983, and to the previous 10-percent manufacturers excise tax from January 7, 1983, until its replacement by the retail tax on April 1, 1983. In addition, refunds of the 10-percent excise tax would be allowed to manufacturers of piggyback trailers sold to ultimate consumers after December 2, 1982.

5. S. 1807—Senators Percy and Dixon

Exclusion of Certain Foreign Agricultural Commodity Income as Foreign Personal Holding Company Income

Present Law

In the Revenue Act of 1962, Congress enacted legislation intended to tax certain tax haven and other tax avoidance income of foreign corporations established by U.S. taxpayers. Before this legislation, a U.S. taxpayer could accumulate income outside the United States or engage in tax avoidance transactions through a foreign corporation (often located in a tax haven country) and not pay U.S. tax on that income until the corporation paid a dividend to the U.S. shareholder.

Under the 1962 legislation (Code secs. 951 through 964, often referred to as subpart F), U.S. shareholders of controlled foreign corporations are subject to current taxation on their proportionate share of certain categories of undistributed profits from tax haven type activities and certain other activities of controlled foreign corporations (subpart F income). Foreign taxes paid on income taxed to the shareholders can be credited against any U.S. tax imposed. One category of subpart F income is foreign base company income. Foreign base company income includes foreign personal holding company income. Dividends and other passive income are considered foreign personal holding company income. Generally, a dividend received by a controlled foreign corporation is treated as subpart F income taxable to the U.S. shareholders even if the payor corporation's income is not subpart F income. Foreign base company sales income includes income of a foreign corporation from the purchase and sale of personal property where the property is produced outside the country of incorporation of the corporation and it is sold for use, consumption, or disposition outside of that country. The rule applies if either the seller to or the purchaser from the foreign corporation is related to it. Income received by a controlled foreign corporation is not taxable under subpart F if it is established to the satisfaction of the Secretary of the Treasury that the foreign corporation was not formed or availed of to reduce taxes.

In 1975, the definition of foreign base company sales income was amended to exclude from taxation income of a controlled foreign corporation from the sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

Issues

The issue presented is whether dividend income received by a U.S. corporation's foreign subsidiary should be excluded from the

Explanation of the Bill

For purposes of subpart F, the bill would exclude from foreign personal holding company income certain dividends received by a controlled foreign corporation from another foreign corporation if certain conditions are met. These conditions are:

(1) The dividends are out of the earnings and profits of the payor corporation for a taxable year in which at least 70 percent of its gross income (other than gross income taken into account in determining subpart F income) is from the purchase or sale of agricultural commodities which were not grown in the United States in commercially marketable quantities;

(2) The two corporations are members of the same affiliated group;

(3) A U.S. shareholder owns (within the meaning of Code section 958(a)) more than 50 percent of the stock of both corporations;

(4) The dividend-receiving corporation and either the payor corporation or another foreign corporation controlled by the payor corporation on the date of acquisition[1] was in existence for at least the five years immediately before the acquisition of its stock by the U.S. shareholder; and

(5) The payor corporation or the other foreign corporation controlled by it was engaged in the active conduct of a trade or business during the five-year period just described.

Thus, provided the above conditions are met, when agricultural commodities which are not grown in the United States in commercially marketable quantities are purchased or sold by a foreign corporation and that corporation pays a dividend to a related controlled foreign corporation, the dividend would not be considered foreign personal holding company income for purposes of subpart F and would not be subject to taxation to the U.S. shareholders.

It is understood that Consolidated Foods Corporation would be the primary beneficiary of this amendment although other similarly situated taxpayers would also be affected.

Effective Date

The provisions of the bill would apply to taxable years of foreign corporations which begin after 1983 and to taxable years of U.S. shareholders within which or with which the taxable years of the foreign corporations end.

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[1] The date of acquisition referred to here in the bill is apparently the date of acquisition of the payor corporation's stock by the U.S. shareholder.

98TH CONGRESS
1ST SESSION

S. 499

[Report No. 98–22]

To require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 16 (legislative day, FEBRUARY 14), 1983

Mr. D'AMATO (for himself, Mr. LEVIN, Mr. TSONGAS, Mr. HUDDLESTON, Mr. ROTH, and Mr. WEICKER) introduced the following bill; which was read twice and referred to the Committee on Small Business

MARCH 11 (legislative day, MARCH 7), 1983

Reported by Mr. D'AMATO, with an amendment

[Strike out all after the enacting clause and insert the part printed in italic]

MAY 11 (legislative day, MAY 9), 1983

Referred, pursuant to Rule XXV(o)(2) of the Standing Rules of the Senate, to the Committee on Finance

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A BILL

To require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

~~That section 503 of the Small Business Investment Company Act of 1958 is amended by adding at the end thereof the following new subsection:~~

~~"(e)(1) The Administration shall not decline to participate in a project under this section which otherwise meets the requirements of this section because other sources of financing for the project include or are collateralized by obligations described in section 103(b) of the Internal Revenue Code of 1954.~~

~~"(2) Loans made with the proceeds of debentures guaranteed under this section may be subordinated to other obligations.~~

~~"(3) The Administration and any other agency of the Federal Government shall not restrict the use of debentures guaranteed under this section with obligations described in section 103(b) of the Internal Revenue Code of 1954 if the project being so financed otherwise complies with the regulations and procedures of the Administration.".~~

SECTION 1. This Act may be cited as the "Certified Development Company Improvement Act".

SEC. 2. Section 503(a)(2) of the Small Business Investment Act of 1958 is amended by striking "Such guarantees" and inserting in lieu thereof "Except as provided in subsection (e), such guarantees".

SEC. 3. Section 503(a)(4) of the Small Business Investment Act of 1958 is amended to read as follows:

"(4) Any debenture issued by any State or local development company with respect to which a guarantee is made under this section, or any loan made with the proceeds of such debenture guaranteed under this section—

"(A) in the case of financings for projects which include or are collateralized by obligations described in section 103(b) of the Internal Revenue Code of 1954, shall be subordinated by the Administration to any such obligation; and

"(B) in case of financings for projects which do not include and are not collateralized by obligations described in section 103(b) of the Internal Revenue Code of 1954, may be subordinated by the Administration to any other debenture, promissory note, or other debt or obligation of such company.".

SEC. 4. Section 503 of the Small Business Investment Act of 1958 is amended by adding at the end thereof the following new subsection:

"(e)(1) The Administration shall not decline to participate in a financing of a project under this section which otherwise meets the requirements of this section because sources of financing for the project include or are collateralized by

obligations described in section 103(b) of the Internal Revenue Code of 1954.

"(2) The Administration and any other agency or official of the Federal Government shall not restrict the use of debentures guaranteed under this section with obligations described in section 103(b) of the Internal Revenue Code of 1954 if the project being so financed otherwise complies with the requirements of this section.".

SEC. 5. (a) Section 102 of the Small Business Investment Act of 1958 is amended by inserting "(a)" after the section number, and adding at the end thereof the following:

"(b) With respect to the program authorized by sections 404 and 405 of this Act, it is the declared policy of the Congress that the guarantee of payments for use of pollution control facilities would not cause the interest on tax-exempt obligations to finance such facilities to be included in the gross income of the bondholders.".

(b) Section 404(b)(1) of the Small Business Investment Act of 1958 is amended by striking the phrase "the guarantee authorized in the case of pollution control facilities or property may be issued" and inserting in lieu thereof "and subject only to the existence of qualified guarantee applications of eligible small business concerns and within the authority available to the administration, the administration shall not

decline to issue the guarantee authorized in the case of pollution control facilities or property".

Amend the title so as to read: "A bill to require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program and Pollution Control Equipment Contract Guarantee Program.".

98TH CONGRESS
1ST SESSION

S. 831

To amend the Internal Revenue Code of 1954 to allow home equity conversions through sale-life tenancy arrangements.

IN THE SENATE OF THE UNITED STATES

MARCH 16 (legislative day, MARCH 14), 1983

Mr. SPECTER introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to allow home equity conversions through sale-life tenancy arrangements.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (d) of section 121 of the Internal Revenue Code of 1954 (relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55) is amended by adding at the end thereof the following new paragraphs:

"(9) SALE OR EXCHANGE DEFINED.—For purposes of this section, the term 'sale or exchange' shall include a transaction in which the seller retains a life tenancy in the property.".

(b) Subsection (h) of section 167 of such Code (relating to depreciation for life tenants and beneficiaries of trusts and estates) is amended to read as follows:

"(h) LIFE TENANTS.—

"(1) GENERAL RULE.—In the case of property held by one person for life with remainder to another person, the deduction shall be computed, except in a transaction described in paragraph (2), as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

"(2) SECTION 121 SALE OR EXCHANGE.—In the case of property held by one person for life with remainder to another person, pursuant to a sale or exchange under section 121, the deduction shall be computed as if the remainderman were the absolute owner and shall be allowed to the remainderman;".

(c) Section 167 of such Code (relating to depreciation) is amended by adding after subsection (h) the following new subsection:

"(i) BENEFICIARIES OF TRUSTS AND ESTATES.—

"(1) BENEFICIARIES OF TRUSTS.—In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"(2) Beneficiaries of estates.—In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.".

(d) The amendments made by this Act shall apply to sales or exchanges after the date of the enactment of this Act, in taxable years ending after such date.

98TH CONGRESS
1ST SESSION

S. 842

To amend the Internal Revenue Code of 1954 to provide tax incentives for the issuance of small business participating debentures.

IN THE SENATE OF THE UNITED STATES

March 17 (legislative day, March 14), 1983

Mr. Weicker (for himself, and Mr. D'Amato, Mr. Heinz, Mr. Nunn, Mr. Boren, Mr. Baucus, Mr. Hatch, Mr. Stevens, Mr. Rudman, Mr. Hollings, Mr. Cochran, and Mr. Huddleston) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide tax incentives for the issuance of small business participating debentures.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF INCOME, GAINS, LOSSES, ETC. ON SMALL BUSINESS PARTICIPATING DEBENTURES.

(a) Capital Gains Treatment of Earnings.—Part IV of subchapter P of chapter 1 of the Internal Revenue Code of 1954 (relating to special rules for determining capital gain and loss) is amended by adding at the end thereof the following new section:

"SEC. 1256. EARNINGS DISTRIBUTIONS UNDER SMALL BUSINESS PARTICIPATING DEBENTURES.

"(a) IN GENERAL.—For purposes of this subtitle amounts actually paid during the taxable year to a taxpayer in respect of a small business participating debenture which constitute the distribution of a share of the earnings of the issuer, shall be treated as long-term capital gain.

"(b) SPECIAL RULES FOR PAYMENT.—For purposes of this section and section 163(e)—

"(1) TIME FOR PAYMENTS.—Payments under subsection (a) shall be deemed to have been made on the last day of a taxable year if the payment is on account of such taxable year and is not made later than the time prescribed by law for the filing of the return for such taxable year (including extensions thereof).

"(2) ORDER OF PAYMENTS.—Any payment in respect of a small business participating debenture shall be treated first as a payment of interest until all interest required to be paid under the debenture for such taxable years is paid and then as a payment of earnings.

"(c) SMALL BUSINESS PARTICIPATING DEBENTURE DEFINED.—

"(1) IN GENERAL.—The term 'small business participating debenture' means a written debt instrument issued by a qualified small business which—

"(A) is a general obligation of the qualified small business,

"(B) bears interest at a rate not less than the rate prescribed by the Secretary under section 483(c)(1)(B),

"(C) has a fixed maturity,

"(D) grants no voting or conversion rights in the qualified small business to the purchaser, and

"(E) provides for the payment of a share of the total earnings of the issuer.

"(2) QUALIFIED SMALL BUSINESS.—

"(A) IN GENERAL.—The term 'qualified small business' means any domestic trade or business (whether or not incorporated)—

"(i) the equity capital of which does not exceed $10,000,000 immediately before the small business participating debenture is issued,

"(ii) with respect to which, at the time the small business participating debenture is issued, the face value of all outstanding small business participating debentures issued (including such debenture) does not exceed $1,000,000, and

"(iii) which has no securities outstanding which are subject to regulation by the Securities and Exchange Commission at the time of issuance of the small business participating debenture.

"(B) CONTROLLED GROUPS.—For purposes of determining under subparagraph (A) the equity capital and outstanding small business participating debentures of—

"(i) a member of the same controlled group of corporations (within the meaning of section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a)(1)), and

"(ii) a member of a group of trades or businesses (whether or not incorporated) which are under common control, as determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i), the equity capital and outstanding debentures of all members of such group shall be taken into account.

"(C) EQUITY CAPITAL.—For purposes of this paragraph—

"(i) CORPORATION.—In the case of a corporation, the term 'equity capital' means the aggregate amount of money and other property (taken into account, in an amount, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject of which were assumed by the corporation at such time) received by the corporation for stock, as a contribution to capital, and as paid in surplus.

"(ii) NONCORPORATE BUSINESS.—In the case of a trade or business which is not organized as a corporation, equity capital shall be determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i).

"(D) SECURITIES SUBJECT TO REGULATION BY THE SECURITIES AND EXCHANGE COMMIS-

SION.—For purposes of this paragraph, the term 'security subject to regulation by the Securities and Exchange Commission' means a security—

"(i) registered on a national securities exchange under section 12(b) of the Securities Exchange Act of 1934;

"(ii) registered or required to be registered under section 12(g) of such Act (or which would be required to be so registered except for the exemptions in subparagraphs (B) through (H) of such section); or

"(iii) issued by a company subject to the reporting requirements of section 15(d) of such Act.

"(d) RELATED PARTIES; PERSONAL HOLDING COMPANIES.—

"(1) DEBENTURES ISSUED BY A RELATED PARTY.—Subsection (a) shall not apply to amounts paid in respect of a small business participating debenture issued by a small business in which the taxpayer has an interest.

"(2) DEBENTURES ISSUED BY PERSON HOLDING TAXPAYER'S DEBENTURES.—If—

"(A) a taxpayer acquires a small business participating debenture from a small business, and

"(B) such small business or a person with an interest in such small business acquired, before the acquisition described in subparagraph (A), any such debenture from the taxpayer or any small business in which the taxpayer has an interest,

subsection (a) shall not apply with respect to any payment in respect of a debenture or portion of a debenture which is equal to the amount of the proceeds of any such debenture acquired from the taxpayer or the small business in which the taxpayer has an interest.

"(3) INTERESTED TAXPAYER.—For purposes of this subsection, a taxpayer shall be considered as having an interest in the issuer of a small business participating debenture if—

"(A) in the case of a small business participating debenture issued by a corporation, the taxpayer is considered, under section 318, to own—

"(i) 10 percent or more in value of the stock, or

"(ii) stock which represents 10 percent or more of the voting rights;

in the corporation or in a corporation which is a member of the same controlled group of corporations (within the meaning of section 1563(a)), or

"(B) in the case of a small business participating debenture issued by a small business not organized as a corporation, the taxpayer owns, or is considered to own (under regulations prescribed by the Secretary similar to the regulations prescribed under section 318), more than 10 percent of the profits or capital in the business.".

(b) INTEREST DEDUCTIBLE AS INTEREST EXPENSE.—Section 163 of such Code (relating to interest) is amended by redesignating subsection (e) as (f) and by inserting after subsection (d) the following new subsection:

"(e) INTEREST AND OTHER AMOUNTS PAID ON SMALL BUSINESS PARTICIPATING DEBENTURE.—For purposes of this section (other than subsection (d)), amounts paid as interest, and amounts paid as a share of earnings, on a small business participating debenture (as defined in section 1256(b)) shall be treated as interest.".

(c) TREATMENT OF ORIGINAL ISSUE DISCOUNT INTEREST.—Section 1232 of such Code (relating to bonds and other evidences of indebtedness) is amended by adding at the end thereof the following new subsection:

"(e) SMALL BUSINESS PARTICIPATING DEBENTURES.—Any small business participating debenture (as defined in section 1256(b)) issued by a trade or business other than a corporation shall be treated, for purposes of this section, as if it were issued by a corporation.".

(d) LOSSES ON SMALL BUSINESS PARTICIPATING DEBENTURES TREATED AS ORDINARY LOSS.—Section 1244 of such Code (relating to losses on small business stock) is amended by adding at the end of subsection (d) the following new paragraph:

"(5) SMALL BUSINESS PARTICIPATING DEBENTURES TREATED SAME AS SECTION 1244 STOCK.—For purposes of this section, any loss on a small business participating debenture (as defined in section 1256(c)) issued to an individual shall be treated as if it were a loss on section 1244 stock issued to that individual.".

(e) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following new item:

"Sec. 1256. Earnings distributions under small business participating debentures.".

SEC. 2. EFFECTIVE DATE.

(a) IN GENERAL.—Except as provided in subsection (b), the amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1982, and to small business participating debentures acquired after the date of enactment of this Act.

(b) PROCEEDS USED TO REPAY LOANS.—The amendments made by this Act shall not apply to any small business participating debenture issued before or during calendar year 1983 if the proceeds of such debenture are used to repay any loan of the issuing small business other than a loan—

(1) with a stated rate of interest in excess of the prevailing rate of interest for businesses in the area in which such small business is located, and

(2) secured by the inventory or accounts receivable of such small business.

98TH CONGRESS
1ST SESSION

S. 1231

To amend the Internal Revenue Code of 1954 to exempt certain piggyback trailers and semitrailers from the tax on motor vehicles.

IN THE SENATE OF THE UNITED STATES

MAY 6 (legislative day, MAY 2), 1983

Mr. BOREN (for himself, Mr. MATSUNAGA, Mr. MITCHELL, Mr. SYMMS, and Mr. BAUCUS) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to exempt certain piggyback trailers and semitrailers from the tax on motor vehicles.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (8) of section 4063(a) of the Internal Revenue Code of 1954 (relating to exemptions for specified articles) is amended to read as follows:

"(8) RAIL TRAILERS, RAIL VANS AND PIGGYBACK TRAILERS.—

"(A) IN GENERAL.—The tax imposed by section 4061 shall not apply in the case of—

"(i) any chassis or body of a trailer or semitrailer which is designed for use both as a highway vehicle and a railroad car,

"(ii) any chassis or body of a piggyback trailer or semitrailer, and

"(iii) any parts or accessories designed primarily for use in connection with an article described in clause (i) or (ii).

"(B) PIGGYBACK TRAILER OR SEMITRAILER DEFINED.—For purposes of this paragraph, the term 'piggyback trailer or semitrailer' means any trailer or semitrailer—

"(i) which is designed for use principally in connection with trailer-on-flatcar service by rail, and

"(ii) with respect to which the seller certifies, in such manner and form and at such time as the Secretary prescribes by regulations, that such trailer or semitrailer—

"(I) will be used, or resold for use, principally in connection with such service, or

"(II) will be incorporated into an article which will be so used or resold.".

(b) The amendment made by subsection (a) shall take effect as if included in the amendment made by section 512(a)(3) of the Highway Revenue Act of 1982.

II

98TH CONGRESS
1ST SESSION

S. 1807

To amend the Internal Revenue Code of 1954 to clarify the taxation of certain income derived from agricultural commodities not grown in the United States in commercially marketable quantities.

IN THE SENATE OF THE UNITED STATES

AUGUST 4 (legislative day, AUGUST 1), 1983

Mr. PERCY (for himself and Mr. DIXON) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to clarify the taxation of certain income derived from agricultural commodities not grown in the United States in commercially marketable quantities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 954(c)(4) of the Internal Revenue Code of 1954 (relating to certain income received from related persons) is amended:

(1) by adding at the end thereof the following new subparagraph:

"(D) dividends received from a related person, but only if—

"(i) the recipient and payor of such dividends are foreign corporations that are members of the same affiliated group (as defined in section 1504(a), but without the application of section 1504(b)(3)),

"(ii) a United States shareholder owns (within the meaning of section 958(a)) more than 50 percent of the stock of both corporations,

"(iii) the recipient and either the payor or another foreign corporation controlled by the payor on such date of acquisition was in existence for at least the 5-year period ending immediately prior to the date of acquisition of its stock by the United States shareholder,

"(iv) either the payor or such other foreign corporation was engaged in the active conduct of a trade or business during such 5-year period described in clause (iii), and

"(v) such dividends are paid out of the earnings and profits of such person for a taxable year in which at least 70 percent of its gross income (other than gross income taken into account in determining the amounts described in section 952(a)) was derived from the purchase or sale of agricultural commodities which were not grown in the United States in commercially marketable quantities (within the meaning of subsection (d)(1)).";

(2) by striking the "and" at the end of subparagraph (B); and

(3) by striking the period at the end of subparagraph (C) and adding in lieu thereof "; and".

(b) The amendment made by subsection (a) shall apply to taxable years of foreign corporations beginning on or after January 1, 1984, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end.

98TH CONGRESS
1ST SESSION

S. 1914

To amend the Internal Revenue Code of 1954 to facilitate home equity conversions through sale-leaseback transactions.

IN THE SENATE OF THE UNITED STATES

OCTOBER 3, 1983

Mr. SPECTER introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to facilitate home equity conversions through sale-leaseback transactions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

That this Act may be cited as the "Home Equity Conversions Act of 1983".

SEC. 2. DEPRECIATION IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Section 167 of the Internal Revenue Code of 1954 (relating to depreciation) is amended by inserting after subsection (h) the following new subsection:

"(i) QUALIFIED SALE-LEASEBACK TRANSACTIONS.—

"(1) IN GENERAL.—In the case of property involved in a qualified sale-leaseback transaction, the deduction shall be computed as if the purchaser-lessor were the absolute owner of the property and shall be allowed to the purchaser-lessor.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) QUALIFIED SALE-LEASEBACK.—The term 'qualified sale-leaseback' means a transaction in which—

"(i) the seller-lessee—

"(I) has attained the age of 55 before the date of such transaction,

"(II) sells property which was owned and used by such seller-lessee solely as a principal residence and not as section 1250 property before the date of such transaction, and

"(III) retains occupancy rights in such property pursuant to a written lease requiring a fair rental, and

"(ii) the purchaser-lessor—

"(I) is a person, and

"(II) is contractually responsible for the risks and burdens of ownership after the date of such transaction.

"(B) OCCUPANCY RIGHTS.—The term 'occupancy rights' means the right to occupy for a term which—

"(i) equals or exceeds one-half of the life expectancy of the seller-lessee at the date of the qualified sale-leaseback transaction (and his spouse, in the case of jointly-held occupancy rights),

"(ii) is subject to a continuing right of renewal by the seller-lessee (or his surviving spouse in the case of jointly-held occupancy rights), and

"(iii) terminates no later than the date of death of the seller-lessee (or his surviving spouse in the case of jointly-held occupancy rights).

"(C) FAIR RENTAL.—The term 'fair rental' means a rental pursuant to a qualified sale-leaseback transaction which is determined at the date of such transaction and equals or exceeds 80 percent of the appraised fair market rent.".

SEC. 3. CAPITAL GAINS EXCLUSION IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Subsection (d) of section 121 of the Internal Revenue Code of 1954 (relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55) is amended by adding at the end thereof the following new paragraph:

"(9) SALE OR EXCHANGE DEFINED.—For purposes of this section, the term 'sale or exchange' shall include a qualified sale-leaseback transaction as defined in section 167(i).".

SEC. 4. INCOME TO SELLER IN QUALIFIED SALE-LEASEBACK TRANSACTION.

(a) GROSS INCOME.—Part III of subchapter B of chapter 1 of subtitle A of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by inserting after section 121 the following new section:

"SEC. 121A. OCCUPANCY RIGHTS IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

"Gross income does not include any value of occupancy rights or fair market price discount attributable to retained occupancy rights received in a qualified sale-leaseback transaction as defined in section 167(i).".

(b) GAIN OR LOSS.—Subsection (b) of section 1001 of such Code is amended—

(1) by striking out "and" at the end of paragraph (1),

(2) by striking out the period at the end of paragraph (2) and inserting in lieu thereof ", and", and

(3) by inserting after paragraph (2) the following new paragraph:

"(3) in the case of a qualified sale-leaseback transaction (as defined in section 167(i))—

"(A) there shall not be taken into account any value of occupancy rights or fair market price discount attributable to retained occupancy rights, and

"(B) there shall be taken into account the cost of any annuity purchased for a seller.".

(c) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of subtitle A of such Code is amended by inserting after the item relating to section 121 the following new item:

"Sec. 121A. Occupancy rights in qualified sale-leaseback transactions.".

SEC. 5. INSTALLMENT SALES IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Section 453 of the Internal Revenue Code of 1954 (relating to installment method) is amended—

(1) by redesignating subsection (j) as subsection (k), and

(2) by inserting after subsection (i) the following new subsection:

"(j) APPLICATION WITH SECTION 167(i).—

"(1) IN GENERAL.—In the case of an installment sale in a qualified sale-leaseback transaction (as defined in section 167(i)), subsection (a) shall apply.

"(2) SPECIAL RULE FOR ANNUITIES.—In the case of an annuity purchased for the seller-lessee by the purchaser-lessor in a qualified sale-leaseback transaction, the purchase cost of such annuity shall constitute the amount of consideration received by such seller-lessee attributable to such annuity and shall be deemed received in the year of disposition.".

SEC. 6. BASIS OF ANNUITY RECEIVED IN QUALIFIED SALE-LEASEBACK TRANSACTION.

Subparagraph (A) of section 72(c)(1) of the Internal Revenue Code of 1954 (relating to annuities) is amended by inserting before the comma "(including such amount paid by a purchaser-lessor in a qualified sale-leaseback transaction defined in section 167(i))".

SEC. 7. QUALIFIED SALE-LEASEBACK TRANSACTION ENGAGED IN FOR PROFIT.

(a) FOR PROFIT PRESUMPTION.—Section 183 of the Internal Revenue Code of 1954 (relating to activities not engaged in for profit) is amended—

(1) by striking out "If" in subsection (d) and inserting in lieu thereof "(1) In general.—If",

(2) by inserting after paragraph (1) of subsection (d) (as designated by paragraph (1)) the following new paragraph:

"(2) Qualified sale-leaseback transaction.—Any qualified sale-leaseback transaction as defined in section 167(i), unless the Secretary establishes to the contrary, shall be presumed for purposes of this chapter to be an activity engaged in for profit.", and

"(3) by inserting "(1)" after "subsection (d)" each place it appears in subsection (e).".

(b) Use of Dwelling Unit.—Subparagraph (B) of section 280A(d)(3) of such Code (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended to read as follows:

"(B) Special rules for rental to person having interest in unit.—

"(i) Rental agreement.—Subparagraph (A) shall apply to a rental to a person who has an interest in the dwelling unit only if such rental is pursuant—

"(I) to a shared equity financing agreement, or

"(II) to an agreement entered into pursuant to a qualified sale-leaseback transaction defined in section 167(i).

"(ii) DETERMINATION OF FAIR RENTAL.—Fair rental shall be determined as of the time the agreement is entered into and—

"(I) in the case of a shared equity financing agreement, by taking into account the occupant's qualified ownership interest, and

"(II) in the case of an agreement entered into pursuant to a qualified sale-leaseback transaction, by complying with the requirements of section 167(i)(2)(C).".

SEC. 8. EFFECTIVE DATE.

The amendments made by this Act shall apply to sales after the date of the enactment of this Act, in taxable years ending after such date.

STATEMENT OF SENATOR DAVE DURENBERGER ON S. 842

As a cosponsor of S. 842, I want to thank the chairman and members of the subcommittee for allowing me an opportunity to express my thoughts about small business participating debentures and especially for its cooperation in soliciting testimony with regard to this bill.

Mr. Chairman, few of us present today would deny that small businesses are proven technological innovators and job creators, two vital economic stimuli sorely missed in today's economy. It is high time Congress devoted them the legislative attention they justly deserve.

Even more so than their corporate cousins, "The President's Report to Congress on the State of Small Business," noted that they are equity rich and cash poor. The high debt-to-equity ratio often carried by these businesses clearly indicates that they depend extensively on current debt.

Debt reliance, especially in light of the high risk nature of new small businesses, means that small business owners must depend upon inflexible, expensive sources of financing. In addition, this means they are subject to the aims of economic changes beyond their control. This explains why high interest rates have decimated existing small businesses, evidenced by our alarming bankruptcy rate, and hindered investment in new business ventures.

Unfortunately, they have no financing alternative. While existing small businesses are often equity rich, they currently have little leeway in utilizing it to generate less expensive, more flexible capital without giving up control over their company to outside investors.

Small business participating debentures provide them a new opportunity to raise valuable inexpensive, longer term capital. They allow business owners to share some of their risk but let the investor reap part of the profit generated as a result.

S. 842, as you will hear in upcoming testimony, also contains safeguards guaranteeing that SBPDS will not be abused and will aid only those for whom it is intended, America's small businesses.

You are going to hear a lot more about participating debentures from this list of truly stellar witnesses. In the meantime, a lot of our small business owners eagerly await help from the cavalry in the form of SBPDS.

STATEMENT OF SENATOR BOREN ON S. 842

Mr. Chairman: Your Subcommittee is considering legislation today that has significant implications for the ability of our nations' small businesses to continue to grow and prosper during these uncertain economic times. I am an original co-sponsor of S. 842, an act to amend the Internal Revenue Code of 1954 to provide tax incentives for the issuance of small business participating debentures.

I want to thank the Chairman of the Small Business Committee, Senator Weicker, for taking the lead in introducing this bill. Senator Weicker first introduced SBPD legislation in July of 1979 and his persistence in pushing this concept is certainly commendable.

I also want to thank the Chairman of this Subcommittee, Senator Packwood for agreeing to hold hearings on this important bill.

S. 842, which creates a SBPD, will be new source of capital for small businesses. During these difficult economic times, it has been hard, if not impossible, for small businesses to find adequate and affordable capital for expansion. Interest rates charged by banks and other lending institutions have made it virtually impossible for small businesses to obtain needed capital for growth.

The SBPD, a unique cross between a stock and a bond, will allow small businesses to gain capital for expansion without having to go public through a stock offering. A small business will administer the SBPD and will issue it as a general obligation with a fixed maturity date. The SBPD will carry a fixed nominal rate of interest and offer the investor a varying share of the company's profits for the period the SBPD is in effect. The SBPD will allow the owner to retain full control of the business, receive low-cost capital and deduct as a business expense both the interest payments and the share of the earnings paid to the investor.

The investors interest on the SBPD will be taxed as ordinary income, but the share of the company's earnings would be taxed at the more preferential long-term capital gains rate.

It has been estimated that as many as 2,000 small businesses across the country would take advantage of the SBPD.

Mr. Chairman, for our nation to continue on the road to economic recovery, small businesses must play a major role in this process. But they can't play this role without the needed capital to expand. During the last decade, small businesses provided almost 90 percent of all new jobs. It is apparent that our continued economic recovery depends on the health of the small business sector.

S. 842 will be a step in the right direction toward helping our small businesses survive.

Statement of Senator David L. Boren on S. 1231

Mr. Chairman: Back in December during the closing hours of debate on the Surface Transportation Act of 1982, I became aware of a gross inequity that exempted from the 12% Federal sales tax a rail vehicle known as RoadRailer to the exclusion of a vehicle made and used for the same purpose, a Piggyback trailer.

Today, I would like to discuss measures to correct this inequity and take this opportunity to briefly outline the background and facts.

Piggyback trailers pay the full 12% Federal sales tax even though they travel the same low mileage as a RoadRailer, and are designed and serve the same purpose as a RoadRailer. Both RoadRailer and Piggyback trailer travel from the loading dock to the rail yard to be transferred for the long haul by rail. The basic difference between the RoadRailer and a Piggyback trailer is that the RoadRailer has a set of train wheels to travel on the rail, while the Piggyback trailer is lifted onto a flat car to travel on the rail. Both types of trailers are specifically designed and manufactured to serve the same purpose. In addition, both types of trailers travel the same land mileage, which usually averages less than 3,000 miles a year. As a result of the difference in tax treatment for vehicles doing the same job, Piggyback trailers are put at a competitive disadvantage to the RoadRailer.

The Department of Transportation states in its Final Report on Federal Highway Cost Allocation, "Consideration should be given to relieving truck trailers that are manufactured for use as Piggyback trailers from the new truck excise tax."

Piggyback trailers cost more to build and weigh about one thousand pounds more than an over-the-road trailer, and are certified to travel on the rail by the American Association of Railroads. They therefore would not represent an enforcement burden if exempted from the sales tax as is their competitor the RoadRailer.

The 13 million dollars a year loss of revenue for exempting Piggyback trailers would be offset by savings in wear and tear to the national highways, and statistics show it is immersurably safer than over the road trailer transportation.

I hope this committee will support me in putting equity to work in the interest of transportation policy by correcting this oversight in the 1982 Act.

Senator **Packwood**. The committee will come to order.

We are about 5 minutes early, but Senator Weicker is here, and we have a good many witnesses testifying and I fear we are going to be interrupted with votes today. As long as Senator Weicker is here and ready to go, I would just as soon start.

Senator Weicker, the chairman of the Small Business Committee.

STATEMENT OF HON. LOWELL WEICKER, U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator **Weicker**. Thank you very much, Mr. Chairman. I appreciate your kindness in allowing me to testify at this time.

It is a pleasure to be here today as the Senate Finance Committee considers two bills of enormous importance to small business and the goal of increased job creation in our society.

I have a longer statement which I would like to have inserted in the record, but for the purposes of time I will summarize the main points of that testimony now.

I am not going to talk very much about S. 499; that's Senator D'Amato's bill. And while I'm a supporter of that legislation, I have complete confidence in the ability of Al to argue convincingly on its behalf.

Let me just say that 499 links two of the most effective and productive economic development tools available today: IDB's, and the SBA's 503 program, in order to give small businesses long-term financing for bricks and mortar development at—and this is important—reasonable rates of interest. It's a good solid piece of legislation that was unanimously reported out of the Small Business Committee over 6 months ago.

Now, as to S. 842.

I can't tell you how pleased I am, Mr. Chairman, to see the Finance Committee holding a hearing on this legislation. It has been a long drawn-out process to bring us to this point, and I can't help but feel encouraged and somewhat vindicated to see we have come this far.

I first introduced legislation to create a small business participating debenture in 1979. As then ranking minority member on the Small Business Committee, I was concerned that owners of small businesses needed a way to get necessary external capital without having to plunge deeply into debt at ridiculously high interest rates or sell off part of their business to finance the loan.

The idea for this originally came from people at Arthur Andersen who we were working with, and as you know it was one of the highest-priority items at the White House Small Business Conference that took place in Washington—and it still is one of the highest-ranking items on the Small Business legislative agenda.

The SBPD would operate as a cross between a stock and a bond. Small business owners who want to expand but who for a variety of reasons do not want to go public or use official financing would issue the SBPD themselves as a general obligation with a fixed maturity date. The SBPD would carry a fixed nominal rate of interest and would offer the investor a negotiated share of, or participation in, the company's profit for the period it was in effect.

The advantages of this kind of instrument are many. It allows a small business owner to retain total ownership and management control of his business, while at the same time providing him with the external capital he needs.

It offers the investor a chance to put his money in a successful growing business, with his share of the earnings taxed at the preferential long-term capital gains rate.

As with any debt, the investor's interest on the SBPD of course would be taxed as ordinary income. The business owner would be allowed to deduct both interest payments and share on earnings on the SBPD as a regular business expense.

In the 5 years since I introduced this concept, the SBPD has been the subject of considerable study and scrutiny by a wide-ranging assortment of people both in the public and private sectors.

My colleague from our other distinguished body, Congressman Eckart, has won substantial House support for the SBPD as a result of his strong advocacy in its behalf.

The White House Conference on Small Business, which brought together educators, legislators, tax policy experts, and small business owners named the SBPD one of its top-10 recommendations in 1980.

Last year the Government Business Forum on Capital Formation, a nationwide think tank held by the SEC, voted the SBPD first among its recommendations for improving capital access for small firms; and in May of this year Small Business United, a coalition of grassroots small business groups across the country, came to Washington with a list of five priorities, and No. 1 was to pass the SBPD bill.

Mr. Chairman, I know this committee doesn't base its decisions or its actions on how popular a particular issue is, and I hope that no one here thinks that that is what I'm advocating. I recognize that some very real concerns have been raised in connection with this bill, particularly in terms of its revenue impact.

The Treasury Department has indicated that this bill would be a revenue loser for the Federal Government, and I know that concerns you. Frankly, it concerns me, because I am one of the guys who has been out there shouting the loudest that we've got to do something to bring our deficits down and increase our revenues. But I don't think I'm being inconsistent by advocating this bill today. In my opinion the SBPD is a revenue-raiser, not a loser. In fact, in 1980 the Joint Tax Committee specifically stated that their revenue loss calculations do not reflect additional tax revenues generated from the small business sector financed through SBPD's.

According to the Joint Tax Committee, if you assume a 10-percent return on the SBPD, there will be no loss to the Federal Treasury due to the enactment of this bill. With a 12-percent return and factoring in tax on shareholder income, this bill could raise as much as $2.2 billion.

Needless to say, there is a large disparity of view on this essential question. I am not a tax expert, Mr. Chairman, and there are witnesses who will follow me who are much better qualified than I to discuss the intricacies of revenue estimate methodology and the like; let me just say, however, that in drafting the bill it was never our intention that it be used economywide. Indeed, given its unique nature and limited appeal, we envisaged that it would be used mainly by newer small businesses who have not yet built up their credit base enough to receive preferential treatment from traditional lending sources. As a result, it was our assumption that in only rare occasions would any single issue go above $500,000.

I believe in this concept. I think it's important, Mr. Chairman, that we get it on the books. However, I am also sensitive to the constraints with which this committee has to work and the concerns which these revenue-loss estimates must raise for you.

I would like to suggest two things: The first is, I would be happy and willing to have my staff work with yours in any way necessary to bring those revenue-loss figures down; and second, I would like to request the Joint Tax Committee staff be instructed to prepare a detailed cost breakdown of all the provisions of the bill—in other words, breaking out the cost of each provision, so that we will have some idea of what to tinker with, if further tinkering needs to be done.

Mr. Chairman, that is the essence of my testimony. I think, in conclusion, that there have been some pretty steep prices to be paid because of the economics of the past several years. Unemployment, which you have been so concerned with, certainly has been one of them; the fallout in major corporations that we read about every day in the newspapers has been another. But the price that has been paid by small businesses has been staggering, absolutely staggering, in terms of their being put out of business, in terms of their bankruptcies and failures. And the outyear cost of that is going to be tremendous, because many of those small businesses will not be on the scene to compete let's say 10 years out. And as the competition diminishes, the products get worse and the prices go higher. So, that really is the price that is going to be paid.

Now, there is capital out there; nobody is going to argue that point. I emphasize that "reasonable," "affordable" capital, that's a different story to a small business.

Now, this may be a tough recession on IBM, ATT, and Mobil Oil, but they've got the money and they'll weather it. These small businesses have not been able to weather it. They now need reasonable, affordable capital so that indeed they will be on the scene, to insure that competition will be there, and the products will be there in the outyears.

I would hope that this legislation wouldn't get buried because of the sense that "this isn't the time to do it." This is the very time to do it. And done correctly, I think the revenue losses will be minimal, if indeed at all. And with a strong, healthy small business economy, I think the moneys coming into the Government will more than match whatever losses are incurred.

I thank you for your attention, and I hope you do something.

[Senator Weicker's prepared statement follows:]

EXPANDED STATEMENT OF SENATOR LOWELL WEICKER, JR.
BEFORE THE SUBCOMMITTEE ON TAXATION
ON S. 842 AND S. 499

OCTOBER 28, 1983

Good morning, Mr. Chairman. It's a pleasure to be up here today, as the Finance Committee considers two bills of enormous importance to small business and the goal of increased job creation in our society. I would like to talk first about S. 842, and then move on to Senator D'Amato's bill, S. 499.

As to S. 842, I can't tell you how pleased I am to see the Finance Committee holding a hearing on this legislation. It's been a long, drawn-out provess to bring us to this point, and I can't help but feel encouraged and somewhat vindicated to see that we have come this far.

I first introduced legislation to create a small business participating debenture in 1979. As then-ranking minority member on the Small Business Committee, I was concerned that owners of small businesses needed a way to get necessary external capital without having to plunge deeply into debt at ridiculously high interest rates, or to sell off part of their business to finance the loan.

The SBPD is a new, hybrid financing instrument uniquely suited to the needs of small business. By making affordable capital available, the SBPD will help small firms expand, and thus, will aid in creating the jobs so necessary to maintain our national economic recovery.

The SBPD would operate as a cross between a stock and a bond. Any "qualifying" domestic small business which wants to expand, but which, for whatever reason, does not want to go public, or does not have access to traditional debt financing, would issue the SBPD as a general obligation with a negotiated fixed maturity date. The SBPD would carry a negotiated fixed, nominal rate of interest (not less that the standard imputed rate as determined by the Secretary of the Treasury (currently 6 percent)), as well as offer investors a negotiated share of, or participation in, the company's profits for the period it is in effect. But, an SBPD would not grant any voting or conversion rights in the company.

The advantages to this kind of instrument are many. It allows the small business owner to retain total ownership and management control of his business, while at the same time providing him with the external capital he needs. And, it offers the investor a chance to put his money in a growing business, with his share of the earnings taxed at preferential long-term capital gains rates. As with any debt, the investor's interest on the SBPD would be taxed as ordinary income. The business owner would be allowed to deduct both interest payments and share of earnings on the SBPD as regular business expense. Conversely, since the SBPD would be treated as section 1244 stock, an individual investor would generally treat a loss on an SBPD as an ordinary loss.

So, in effect, the SBPD would have the status of a debt security with a stated rate of interest, but would also provide an inducement for the investor by returning to him a share of the company's earnings during the period the SBPD is outstanding. Because the SBPD would provide for a specific redemption date, the issuing company would effectively be paying a premium for the use of the capital, but only for the period of use.

The SBPD would thus differ from stock warrants and rights, which as a result of the shares issued pursuant to their terms, effectively participate in earnings long after the company has experienced its critical need for funds and repaid them.

The specific terms of the SBPD, such as the interest rate, maturity date and share of earnings, would be determined through arms-length negotiations between the issuer and the investor. Pursuant to the legislation, however, no preferential tax treatment would be afforded where the taxpayer is, or becomes, a "related party" to the company issuing the SBPD. The taxpayer would be deemed to be a "related party" if he has more than a 10-percent interest in the business.

In the five years since I introduced this concept, the SBPD has been the subject of considerable study and scrutiny by a wide-ranging assortment of people, both in the public and private sectors. In 1980 the White House Conference on Small Business, which brought together educators, legislators, tax policy experts and small business owners, named the SBPD one of its top 5 recommendations for improving capital access for small firms.

At last fall's SEC Government-Business Forum on Capital Formation, the SBPD was the top recommendation of over 250 independent small business representatives nation-wide. And again, in May of this year, Small Business United, a coalition of grass-roots small business groups from across the country, came to Washington with its top priority being to pass the SBPD bill. Congressman Eckart and Marriott who have each introduced similar legislation in the House have attracted substantial support for the SBPD as a result of their strong advocacy on its behalf.

I recognize that some real concerns have been raised in connection with this bill, particularly in terms of its revenue impact. The Treasury Department has indicated that this bill would be a revenue loser. However, I find fantastic their projection of an over 5-times greater loss with the SBPD than they foresee from reducing the holding period for long-term capital gains ($3 billion vs. $570 million through 1988). In my opinion, the SBPD is a revenue raiser, not a loser. In 1980, the Joint Committee on Taxation specifically noted that their revenue loss calculations (Exhibit 1):

> do not reflect additional tax revenues that would be generated from expanded business from the small business sector financed through the small business debenture proposal. If it is assumed that a small business entity can earn pre-tax profits of only 10% of the amount of debentures issued, additional tax revenues would be generated at the corporate level sufficient to offset the revenue loss estimate of the Joint Committee. [emphasis mine]

The Joint Committee determined further that:

> If the business entity can earn 12% on funds received through the (SBPD), additional corporate taxes would be $3.3 billion for FY 85 (the then out year), roughly $500,000,000 more than the estimated revenue loss. If we also add the tax that would be imposed at the shareholder level when these earnings are distributed to the owners of the businesses, between $2.2 billion and $2.7 billion could be generated.

So, obviously, there is a large disparity of view on this essential question. I am not a tax expert, and there are others better qualified than I to discuss the intricacies of revenue estimating methodology. But, I nonetheless maintain that a large negative revenue loss estimate simply highlights a fundamental misunderstanding of the inherent nature of the SBPD. The provisions of this bill changing existing law (i.e., both the investor capital gains treatment and the issuer deductibility of the profit participation share), which might adversely impact Treasury revenue, become operative only if and when the borrowing business earns a profit.

I can appreciate that existing governmental revenue impact forecasting methodology does not generally recognize "reflow"; however, the SBPD does automatically trigger reflow because the borrowing business must earn a profit before there is any possible revenue impact.

I am more than willing to adjust different provisions of this bill to ameliorate any undue revenue loss highlighted by the estimate. However, if this is to occur, I would request, and I believe it is imperative that the Joint Committee provide a more detailed breakdown of costs and assumptions used in preparing their impact estimate.

It was never contemplated in the drafting of this bill that the SBPD be used economy-wide. Indeed, given its unique nature and limited appeal -- it requires a business owner to essentially give away, to a complete stranger, the right to participate, or share, in the borrowing business's profits. Any small business resorting to such financing obviously would not have access to conventional fixed-rate debt through more usual lending channels. Immediately coming to mind are new, emerging businesses which have not yet had sufficient time to establish the steady income record necessary to satisfy the debt service projections of most financial institutions.

A 1981 study, commissioned by the SBA's Office of Advocacy, looked at so-called "informal risk capital" lending -- the kind of private, non-institutionalized financing the SBPD is designed to attract. This study found that the average investment by these private sources was no greater than $25,000 in 62 percent of the cases, and in 85 percent of the cases was under $100,000. Thus, only in very rare cases would any single issue of SBPD's go above $500,000. Even though the legislation does currently allow for issues up to $1 million, I certainly don't expect the norm to be anywhere near this maximum.

ADDITIONAL COMMENTS ON TECHNICAL ASPECTS OF THE BILL

Passive Income

It is not the understanding or the intention of the sponsors of this bill that the SBPD be used by companies that exist primarily on "passive income", such as personal holding company income (as defined in IRC Section 543 (a)) or Subchapter S corporation passive investment income (as defined in IRC section 1362 (d)(3)(D)). All of the supporters of this bill are agreed that the main purpose of the SBPD is to provide jobs and recycle capital back into the economic pipeline by making financing available to active, operating domestic businesses and trades. The SBPD is not meant for companies that exist on passive income, whose owners might issue the instruments solely to further leverage or layer their current investment portfolios through "commission" or contingency participation financing, and I am certainly agreeable to putting specific language in the bill to make this very clear.

Personal Use

Similarly, it is not the intention of this bill to allow unincorporated businesses, including sole proprietorships, to issue the SBPD and use the loan proceeds for any personal purpose. Under the existing language, it might be possible for a business to borrow for its owner's benefit against the business' assets, while still enjoying the benefits of SBPD treatment. Such non-business use of the SBPD should be specifically prohibited under the legislation as finally enacted.

Securities Outstanding Subject to Registration

The intent of this legislation is to open up new sources of capital for our nation's small businesses, especially those that have no desire to go public for external capital; thus, there is a limitation on what constitutes a "qualified small business" for purposes of issuing an SBPD. Attached is a letter, dated July 23, 1980, from the General Counsel of the Securities and Exchange Commission (Exhibit II), in which the SEC offers a technical suggestion on an earlier version of this legislation to "remove uncertainty as to its scope". It should be noted that S. 842 would add a new section to the Internal Revenue Code which incorporates this recommendation. Subparagraph (D) of Section 1257(c)(2) would more precisely define "the type of small non-public company whose securities should be afforded special tax treatment under the Bill".

Security Registration

This legislation does not amend federal securities law; it is expected that SBPDs will be offered under the new (1982) limited offering exemption from registration, Regulation D (17 CFR 230.501-506). Further, given the expectation that in most cases, $500,000 will be the maximum face value of SBPDs offered at any one time, such offerings should satisfy Rule 504 (230.504), which provides an exemption from registration for any offering by non-SEC reporting companies which does not exceed $500,000 within the twelve months before and during the offering. While the traditional antifraud provisions of Federal securities law still apply, no specific disclosure is required; nor is there any limitation on the investment sophistication or number of persons (as under former Rule 146) purchasing the securities. No form of general advertising or solicitation, including newspaper advertisements or mass meetings, shall be allowed (unless the offering is made in states that provide for the registration of the securities and the delivery of a disclosure document). Further, the resale of the securities are "restricted" (Rule 144), for at least two years.

Lastly, Form D notices (230.500) must be filed with the SEC main office within 15 days of the first sale, and within 30 days after the last sale; in cases where the offering is completed within a 15 day period, only one notice need be filed to comply.

State "Blue Sky" Laws

Federal and state governments each have separate and autonomous securities laws and regulations. A company selling securities must comply with the laws of each state in which it intends to offer its securities, as well as the existing Federal securities laws. In addition, the fact that a particular offering may be exempt from certain provisions of Federal securities law does not necessarily mean it is exempt from the notice and filing requirements of any particular state laws.

Opinion of the Comptroller of the Currency

Attached is a letter, dated May 21, 1980, from the Comptroller of the Currency (Exhibit III), in which he offers his opinion on whether national banks would be eligible to invest in SBPDs issued by a qualified small business. He concludes:

> It is our opinion that a national bank could purchase the debentures in question, however, not as investment securities but as a means of making a loan to the issuing small business. In making such purchases, the bank would not run afoul of the prohibition against buying shares of stock of a corporation. A debenture is a security, not a share of stock.

The Comptroller also notes:

> Clearly a national bank that purchased SBPDs for its own loan portfolio would not be engaged in dealing in or underwriting securities...This Office would not consider the occasional resale of SBPDs by a national bank to another lending institution, perhaps to gain better liquidity in its assets position, as rising to the level of secondary market activity that is prescribed by the Glass-Steagall Act [of 1933(12 U.S.C. 24,377,378 and 78)]

Technical Corrections

Upon review of S. 842, my staff has pointed out that there are some technical errors that should be corrected:

- Whenever the bill refers to IRC section 125_6_, it is in fact referring to proposed section 125_7_. Likewise, whenever section 163(_e_) is mentioned, section 163 (_g_) is intended;

- On line 13 of page 5 of the bill, mention is made of corporate equity capital, "...to which the property was subject of"..."of" should read "or"...; and
- paragraph (2) (line 22, page 6) was initially inserted in an earlier version of this bill (S. 1481, 96th Cong., 1st Sess.) when the bill was structured to include a tax credit. This paragraph, despite some subsequent reworking, was solely intended for the tax credit. Since it is inconsequential to this bill, it should be deleted.

CONCLUSION

This legislation would go a long way toward helping our Nation's small sized businesses obtain the capital they need for growth. The SBPD concept recognizes the fact that an infusion of new equity into a small business is not necessarily the answer to the capital needs of a business, and provides an alternative form of financing. William C. Penick, testifying on behalf of the National Small Business Association, told the Small Business Committee in 1979 that financing in the form of SBPDs would be of tremendous assistance in solving the small business capital formation problem. His analysis is worth repeating today:

> The business community typically equates capital with equity participation. For years, many have taken for granted the infusion of new equity in a small business as the logical answer to its capital needs. But, with the exception of some venture oriented businesses such as those in high technology areas, equity may be inappropriate for the following reasons:

1.) Small business entrepreneurs generally look with disfavor on selling equity interests. They are independent individuals who dislike regulations at all levels of government. They wish to maintain the confidentiality of their financial positions and operating results. They do not wish to have others tell them how to operate their businesses, even though occasionally they may need outside counsel. They often view outside shareholders as a threat to their freedom of action.

2.) As equity, interest in a small company is generally difficult to liquidate at a fair price. From the viewpoint of the investor, with uncertainty of dividends, little or no voice in management, and no established market for securities, the value of a minority equity interest is often only slightly higher than worthless. On the other hand, the outside shareholders of a small, publicly held company may find the market for his shares so thin that its volatility hinders prudent monitoring as well as current evaluation of its worth.

3.) In what does a minority shareholder of a small business share? Though they may have "gone public" to the extent that less than 50 percent of the voting interests have been purchased by outsiders, many small companies are managed in almost the same manner as when they were privately held. Thus, policy decisions are predicated on the same criteria as before, which often are influenced by the tax and financial postures of the principal shareholders. A minority equity owner is often in an unenviable position.

Banks have traditionally provided a capital needed for growth and expansion of small businesses. This is typically in the form of short-term debt secured by receivables, inventory, of plant and equipment. Term loans, for periods of five to seven years, have have become increasingly difficult to negotiate participate for a small business operations. As such loans ofter utilize all of the available collateral, there is little opportunity for a small business to obtain additional financing when needed, since few investors are interested in unsecured debt.

For reasons discussed above, investment in small business equity securities is similarly rare...

As neither debt nor equity securities have succeeded in meeting the capital needs of many small companies, it seems logical that small business may need a new investment vehicle, a new security acceptable and attractive to both the investing community and to small business...

> The Small Business Participating Debenture proposal... would create an investment vehicle, not presently available, that would be attractive to both lenders and borrowers, and should channel more capital funds into small business entities.

Mr. Chairman, I strongly urge careful consideration of this legislation. If we are to shore up our economy, we must ensure that the foundation -- small business -- is sound. At present, the small business community is starving for capital. This legislation will -- at little cost to the Government -- be of tremendous assistance in providing our Nation's small businesses with the growth capital they urgently need.

S. 499

S. 499 also addresses the need for small business financing to stimulate economic development and job creation. As reported out by the Small Business Committee on March 19, 1983, it concerns two vitally important programs for small businesses authorized under the Small Business Investment Act of 1958: the section 503 Certified Development Company Program and the Pollution Control Equipment Contract Guarantee Program. Both programs are designed to get affordable, long-term capital to small business. Unfortunately, these important programs have been severely restricted by the Administration's policy on tax-exempt financing.

S. 499 would reverse that ill-advised and counter-productive policy by allowing firms to use tax-exempt Industrial Development

Bonds (IDB's) to finance their share of costs for projects funded under the 503 or pollution control program.

Under section 503, the SBA is authorized to guarantee debentures issued by qualified development companies to finance the purchase of land, plants and equipment, i.e., fixed assets, for the expansion of an identifiable small business concern. The section 503 loan can be for as much as 50 percent of the project costs up to $500,000. The other 50 percent must come from the private sector, usually the small business concerns and a bank. The idea of the program is to leverage the SBA guaranteed loan to encourage the private sector to make long-term capital available to small businesses on reasonable terms to create and retain jobs in local communities.

When Congress approved the section 503 program in 1980, the conferees specifically stated that SBA should not decline participation in projects solely because the non-SBA guaranteed portion of the financing came from tax-exempt obligations. In their regulations on the program, SBA followed the Congressional policy. However, in implementing the program, SBA's standard operating procedures, at the insistence of the Department of Treasury and OMB, have been amended to preclude the use of tax-exempt financing with 503 projects. From Committee hearings, it is clear that the Congressional policy needs to be reaffirmed by amending the law.

S. 499 provides that SBA shall participate in qualified 503 projects which use tax-exempt financing; that 503 debentures shall be subordinated to tax-exempt obligations; and that no other department or agency shall restrict the use of 503 debentures in cases were tax-exempt financing is also a source of funds for the project.

In the 2 1/2 years the program has been operating, 445 entities have been licensed as certified development companies under 503. Many of these companies are still getting off the ground, but nonetheless, as of September 30, 2,006 loans, representing a federal guarantee of $384.6 million, had been made under the program. As of October of last year, SBA reported 28,8 [illegible] documented jobs have been created as a result of 503 financings, with an average cost to the government of only $3,990 per job. And, as the number of jobs created climbs, the corresponding cost per job drops steadily lower. In every quarter since the creation of the 503 program, more and more jobs have been created and the federal commitment per job has declined.

Understandably, this "jobs" program has been strongly supported by Congress. In FY 1982, the Congress appropriated $250 million of funds. Unfortunately, the Administration only expended $99.6 million of the appropriated amount, largely due to the restrictions of tax-exempt financing.

In the "jobs bill", P. L. 98-8, passed by Congress this past spring, Congress restated its support for this program by increasing the authorized level of funding for FY 1983 from $250 million to $350 million. To insure that the program reaches its full potential, P. L. 98-8 also directed the Administration to reverse its policy on the use of tax-exempt financing with 503 projects. Although the official figures are not yet available, SBA estimates that around $270 million of the appropriated funds were used.

I think it's important to point out that when S. 499 was called up to be considered by the Senate floor in April, prior to the time the Finance Committee asked for its referral, some concerns were expressed by Senator Metzenbaum and the Finance Committee staff, over certain of its provisions. As I understand it, the Senator had essentially two concerns with the bill as reported by the Small Business Committee, which were: one, that in the event of a default and subsequent liquidation of a project, the Federal government's investment be protected when tax-exempt financing is used; and two, that tax-exempt financing not become the only method of funding 503 projects to the exclusion of all other forms of financing. While I suspect that the data will show that less than 10 percent of the projects financed in FY 83 involved tax-exempt financing, we have sought to address Senator Metzenbaum's concerns. After extensive negotiations, we agreed upon language that would amend S. 499 and addressed both of those concerns, while at the same time preserving the basic intent of the bill as reported out by the Committee. With respect to the concerns raised by Finance Committee, an agreement was made to accept a committee amendment to delete Section 404(b)(1) of the bill. I have attached to this statement copies of the language of both amendments for inclusion in the Finance Committee's record. [Exhibits IV and V]

It is important to note that these amendments to S. 499 would leave intact the recognition of the need for IDB financing in the SBA section 503 certified development program, and would assure that if certain conditions are met, the debentures guaranteed by the Federal government and issued by any state or local development company participating in this program, may be subordinated to sources of financing for the project which include or are collateralized by tax-exempt obligations.

The amendments would also leave intact critical language in the bill which insures that SBA cannot refuse to participate in a project simply because financings for the project includes, or are collateralized by, tax-exempt obligations. Language making clear congressional intent that no other arm or agency of the Federal government shall restrict the use of IDB's in connection with this program, as did the Office of Management and Budget in the past, is also maintained.

The amendment Senator Metzenbaum indicated would be acceptable as far as his objectives are concerned, deals not with whether IDB financing is available in the section 503 program -- because S. 490 clearly spells out that it is and may not be restricted by the Administration -- but rather, the circumstances under which an IDB is given a senior or junior lien position to the debenture issued by the state or local development company. The suggested amendment would provide, in essence, that the debenture issued by the state or local development company shall take a junior lien position to the IDB when two conditions are met by the state or local development company: first, the state or local development company must certify that financing is unavailable without subordination of the tax-exempt obligations;

and second, it must certify that an alternative means of financing at comparable rates and terms does not exist without financing which includes or is collateralized by tax-exempt obligations. When the state or local development company certifies these two conditions, then all debentures issued by the state or local development company and guaranteed by the government must be subordinated to the tax-exempt obligations.

In addition, this amendment would establish as a reserve against losses to the government a revolving fund into which a one time, one percent fee is paid by the borrower when a project is financed in conjunction with tax-exempt obligations. Based on the excellent track record of the program to date, it is anticipated that this fund would not have to be drawn upon very often, if at all. The amendment would also include a sunset of the bill's subordination provision to take effect January 1, 1987, in order to evaluate the results.

I am confident that those amendments would not alter the ability of the vast majority of our certified state and local development companies to utilize this invaluable source of financing on a frequent basis and would recommend that they be considered when the finance Committee reports out S. 499. And the result should be that this unique, job creating program, rather than operating at less than half-capacity, will use the full program authorized by Congress.

Last week, the House Ways and Means Committee reported out H. R. 4170, which would impose further restrictions on the use of IDB's beyond those imposed under the Tax Equity and Fiscal Responsibility Act of 1982. As if that was not bad enough, H. R. 4170 renders moot the thrust of this bill. Clearly, members of both Houses have concerns about the use of IDB's. However, I urge this Committee to note in their consideration of this bill, the beneficiaries of the SBA 503 program and the pollution control program are small businesses. That exception should be recognized even if some feel compelled to impose further restrictions on IDBs.

In addition to amending section 503, S. 499 would revitalize the SBA Pollution Control Equipment Contract Guarantee Program, which, for all intents and purposes, has been dead since January 1, 1982, when the Administration instituted a new policy refusing to allow a government guarantee of a tax-exempt bond.

By amendments in 1976 to the Small Business Investment Act of 1958, Congress authorized the Small Business Administration to guarantee 100 percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities or equipment mandated by governmental pollution control regulations. Contract financing is normally obtained from the proceeds for the sale of tax-exempt bonds issued by state or municipal authorities.

By using tax-exempt, SBA guaranteed pollution control revenue bonds, SBA cooperates with commercial and investment banks and local and state authorities to provide access to long-term, low-interest financing available to eligible small businesses in the same manner that large corporations obtain financing for pollution facilities.

The Small Business Committee has extensively reviewed the benefits of this program. A May, 1981 oversight hearing, and testimony received by the Committee at its February 12, 1982 review of the President's FY 1983 Budget, reconfirmed that this is one of the most successful Small Business Administration programs.

Since the 1976 initiative, there have been few losses in the program and the initial $15 million capital contribution to the pollution control bond revolving fund has nearly tripled through both fees charged for guarantees, and agency investments of idle funds.

Exhibit I

96TH CONGRESS, 2D SESSION

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Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, D.C. 20515

BERNARD M. (BOB) SHAPIRO
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[illegible] L. [illegible]
ASSISTANT CHIEF OF STAFF
JAMES W. WETZLER
CHIEF ECONOMIST

SEP 2 1980

The Honorable Lowell Weicker, Jr.
United States Senate
Washington, D. C. 20510

Dear Senator Weicker:

This is in response to your request for a revenue estimate of legislation creating small business participating debentures (SBPD's). In accordance with a conversation with Mr. Stan Twardy of your staff, we are providing an estimate for S. 2981 rather than for S. 1481, which has, as an additional incentive, a credit against tax for investment in SBPD's.

Below is listed the estimated reduction in fiscal year receipts for S. 2981 assuming enactment in October, 1980.

1981	1982	1983	1984	1985
		($ billions)		
0.1	0.4	1.0	1.8	2.8

Sincerely,

Bernard M. Shapiro

SMALL BUSINESS PARTICIPATING DEBENTURE
REVENUE ESTIMATE CONSIDERATIONS

1. The criteria for qualification for SBPD's are:

    a. Equity capital not to exceed $25 million; and

    b. Total debentures outstanding at any one time of no more than $1 million.

2. The essential tax aspects are:

    a. A stated interest rate, not to exceed the rate imputed under IRC Section 483, which would be deductible by the borrower and fully taxable to the lender; and

    b. A profit participation feature, the payment of which would be deductible by the borrower and taxable to the lender as capital gain.

The first tax element, stated interest, involves no change from present law and should have no revenue effect. The second feature would create a deduction to the borrower (a change from existing law) and capital gain to the lender, thereby reducing the income taxable to the lender by 60% of the amount paid. These changes would reduce tax revenues.

3. Offsetting the tax revenue losses from these changes would be:

a. Taxes on the additional profits generated by the borrower through investment of the funds secured through SBPD's.

b. Taxes on wages paid to persons employed through expansion of business financed by SDPD's.

c. Taxes on profits generated by suppliers of materials and services purchased by the borrower for such expanded operations.

4. The tentative revenue loss calculations made by the Joint Committee are as follows:

		Millions
a.	FY 81	$ 100
b.	FY 82	400
c.	FY 83	1,060
d.	FY 84	1,800
e.	FY 85	2,800

Assumptions made in arriving at these estimates include:

a. Five percent of all eligible firms would participate in fiscal 1981, increasing to 30% by fiscal 1985.

b. The average size of the issue for each participating taxpayer would start at $300,000, increasing to $400,000 by fiscal 1985.

c. The dividend or profit participation element is assumed to be 5% of the face amount of the debenture.

d Twenty-five percent of the SBPD's issued would replace existing debt.

5. On a "worst case" basis, under which the borrower would receive tax benefit from the profit participation element at 46% and the lender would receive tax benefit from capital gain treatment at a 70% rate, the effective tax rate to be applied to the amount of debentures outstanding to arrive at the revenue loss would be 4.6%. Assuming more modest tax benefit factors (a 25% benefit to the borrower and a 35% tax rate to the lender), the overall tax benefit percentage would be 2.3%. Translating this into (1) the number of taxpayers using the small business debenture proposal and (2) the total amount of debentures that must be outstanding to create the revenue losses estimated by the Joint Committee, the following results are determined:

	Fiscal Years				
	81	82	83	84	85
			(Millions)		
JCT Rev. estimate	$ 100	$ 400	$ 1,000	$ 1,800	$ 2,800
Volume ($) of SBPD's required to generate est. losses					
Worst case (÷ by 2.3%)	4,400	17,400	43,500	78,300	121,700
Best case (÷ by 4.6%)	2,200	8,700	21,800	39,100	60,900
If average issue is $400,000 number of companies will be					
BEST -~~Worst~~ case	11,000	43,500	108,800	195,800	304,300
WORST-~~Best~~ case	5,500	21,800	54,400	97,900	152,100

6. These calculations do not reflect additional tax revenues that would be generated from expanded business from the small business sector financed through the small business debenture proposal. If it is assumed that a small business entity can earn pre-tax profits of only 10% of the amount of debentures issued, additional tax revenues would be generated at the corporate level sufficient to offset the revenue loss estimate determined by the Joint Committee. If the business entity can earn 12% on funds received through the small business debenture route, additional corporate taxes would be $3.3 billion for FY 85, roughly $500,000,000 more than the estimated revenue loss.

If we also add the tax that would be imposed at the shareholder level when these earnings are distributed to the owners of the businesses, between $2.2 billion and $2.7 billion could be generated.

Exhibit II

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

JUL 23 1980

The Honorable Lowell P. Weicker
United States Senate
313 Russell Senate Office Building
Washington, D. C. 20510

Re: S. 1481

Dear Senator Weicker:

This responds to your request for the Commission's comments on S. 1481 ("the Bill"), which would amend the Internal Revenue Code of 1954 to provide a credit against tax for investment in small business participating debentures ("debentures") and to provide additional tax incentives for the issuance of such debentures. We understand that the purpose of this Bill is to aid capital formation of privately-held small businesses, and the Commission strongly supports that goal. 1/ Since the Bill does not amend the federal securities laws and embodies complex tax provisions, we have no views on whether the approach taken in the Bill to provide certain tax incentives is an appropriate one. 2/

We do, however, have a technical suggestion. An interpretive problem may be caused by the fact that the Bill uses the phrase "securities regulated by the Securities and Exchange Commission" in the context of excluding the preferential tax treatment available for investors in the debentures if issuing companies have such securities outstanding. Because this phrase is undefined, we propose a technical amendment to the Bill to remove uncertainty as to its scope.

Consistent with our understanding that the purpose of the Bill is to limit favorable tax treatment to securities of small non-public companies, we believe that "a security subject to regulation by the Securities and

---

1/ For a summary of the Commission's recent efforts to reduce unnecessary burdens imposed by the federal securities laws on capital raising by small businesses, See Testimony of Stephen J. Friedman, Commissioner, Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, May 16, 1980, at pp. 5-6 (copy enclosed).

2/ Because the Bill does not amend the federal securities laws, if the debentures are issued, they would be subject to registration under the Securities Act of 1933 unless some exemption were available.

Exchange Commission" should be defined to include:

> "any security
> (A) registered on a national securities exchange under Section 12(b) of the Securities Exchange Act of 1934; or
> (B) registered or required to be registered under Section 12(g)of such Act (or which would be required to be so registered except for the exemptions in subparagraphs (B) through (H) of such section); or
> (C) issued by a company subject to the reporting requirements of Section 15(d) of such Act." 3/

The effect of the parenthetical phrase in clause (B) would be to exclude from the favorable tax treatment afforded by the Bill the securities of publicly held issuers which are exempt from the reporting requirements of the Securities Exchange Act because they: (a) are regulated by state and federal authorities in a manner obviating the imposition of additional requirements under the Act; or (b) are organized and operated for religious, educational, charitable or other eleeomosynary purposes; or (c) are certain agricultural or other specified cooperative organizations. 4/ It does not appear that those characteristics are relevant factors in determining whether an entity

---

3/ This definition could be inserted in proposed Section 44D(e)(3) of the Internal Revenue Code, as added by the Bill. Present Section 44D(e)(3) could be renumbered (e)(4).

4/ Section 12(b) allows a security to be registered on a national securities exchange upon application to the exchange. Each exchange sets its own listing requirements, which generally include such factors as the size of company assets and revenues and number of securities holders.

Section 12(g) requires that every issuer having assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held by 500 or more shareholders, register such security with the Commission.

Section 12(g)(2)(B) exempts from Section 12(g) registration any security issued by an investment company registered pursuant to Section 8 of the Investment Company Act of 1940.

Subparagraph (C) exempts any security, other than a security evidencing nonwithdrawable capital, issued by a savings and loan association or similar institution which is supervised or examined by State or Federal authority.

Subparagraph (D) exempts any security issued by a religious, educational, charitable or other eleeomosynary organization.

(footnote continued)

is the type of small non-public company whose securities should be afforded special tax treatment under the Bill. Therefore, we believe it would be appropriate to include securities of those issuers in the definition of securities subject to regulation by the Commission for purposes of the Bill.

The opinions here expressed are those of the Commission, and do not necessarily reflect the view of the President. These comments are being transmitted to the Office of Management and Budget, and we will inform you of any advice received from that office concerning the relationship of our views to the program of the Administration.

Thank you for giving us the opportunity to comment on the Bill. Please let me know if we can be of any further assistance.

Sincerely,

Ralph C. Ferrara
General Counsel

cc: Mr. Bernard Martin
Office of Management and Budget

4/ (footnote continued)

Subparagraph (E) exempts any security issued by a cooperative association as defined in the Agricultural Marketing Act or a federation of such cooperative associations.

Subparagraph (F) exempts any security issued by a nonprofit mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members, issued to purchasers of its commodities or services.

Subparagraph (G) exempts any security issued by an insurance company if such company is regulated by its domiciliary state and is required to file an annual statement with such regulator.

Subparagraph (H) exempts any interest or participation in any collective trust fund maintained by a bank or an insurance company issued in connection with stockbonus, pension or profitsharing plan meeting the requirements of Section 401 of the Internal Revenue Code or an annuity plan under Section 404(a)(2) of such Code.

Also, issuers who register their securities for sale to the public under the Securities Act of 1933 are subject to the reporting requirements of Section 15(d) of the Securities Exchange Act and must file periodic and other reports as the Commission requires by rule.

Exhibit III

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

May 21, 1980

Dear Senator Weicker:

This is in response to your letter of March 5, 1980, requesting this Office's opinion on whether national banks would be eligible to invest in small business participating debentures issued by qualified small businesses if proposed S.1481 is enacted.

That bill would authorize qualified businesses to issue small business participating debentures ("SBPD") subject to special tax incentives in order to assist small- and medium-sized businesses to obtain capital necessary to finance growth. The proposed legislation would provide investors with incentives to invest in small businesses by allowing a tax credit for such investments. SBPDs, as defined by the proposed legislation, are written debt instruments which are general obligations of the qualified small business issuer. SBPDs would bear a stated rate of interest, have fixed maturities, provide for the payment of a share of the total earnings of the issuer, and would not be granted voting or conversion rights in the issuer's business.

The statute governing the powers of national banks, 12 U.S.C. § 24(7), provides in relevant part that a national bank shall have power

> [t]o exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities

> *and stock* by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association *shall not underwrite any issue of securities and stock*: *Provided*, That the association *may purchase for its own account investment securities* under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . . Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any *shares of stock* of any corporation. (emphasis added)

By virtue of the Glass-Steagall Act, the provisions of which are embodied in the 12 U.S.C. § 24(7) language quoted above, a national bank is generally prohibited from purchasing shares of stock of any corporation for its own account. A national bank may, however, purchase for its own account investment securities, including certain bonds and debentures, subject to such limitations and restrictions as the Comptroller may prescribe.

This Office has defined the term "investment security" as a marketable obligation in the form of a bond, note or debenture which is commonly regarded as an investment security. The term does not include investments which are predominantly speculative. The types of securities which have been generally defined as investment securities include: Type I, obligations of the United States, general obligations of any State or any political division thereof, and other obligations listed in 12 U.S.C. § 24(7); and Type II, obligations of the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, and the Tennessee Valley Authority, and obligations issued by any State or political subdivision for housing, university, or dormitory purposes. National banks may also make certain limited investments in Type III securities, including obligations purchased predominantly on the basis of reliable estimates. *See* 12 C.F.R. § 1 (1979).

It is not apparent from the proposed legislation, however, that SBPDs will be readily marketable. Moreover, no reliable estimate of the ultimate performance of an issuer of such obligation is likely to be possible. The debentures would appear to be predominantly speculative and unavailable for purchase as investment securities by national banks.

It is our opinion that a national bank could purchase the debentures in question, however, not as investment securities but as a means of making a loan to the issuing small business. In making such purchases, the bank would not run afoul of the prohibition against buying shares of stock of a corporation. A debenture is a security, not a share of stock. The definitional sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 highlight this distinction by listing the items separately. Both statutes define the term "security" to encompass a "note, stock, Treasury stock, bond, debenture . . ." and the like. (emphasis added) See 15 U.S.C. §§ 77b(1) and 78c(10). Further support for the distinction in the present instance stems from the fact that the debentures are not convertible and carry no voting rights. There is thus no equity interest involved other than a potential share in earnings. The bank would be relying on the successful operation of the business enterprise in the same way that it relies on the successful operation of any corporate borrower to repay a loan.

The Comptroller's Interpretive Ruling 7.7312 (12 C.F.R. § 7.7312) provides as follows:

> §7.7312 Loan agreement providing for share in profits, income or earnings.
>
> A national bank may take as consideration for a loan a share in the profit, income or earnings from a business enterprise of a borrower. Such share may be in addition to or in lieu of interest. The borrower's obligation to repay principal, however, shall not be conditioned upon the profit, income or earnings of the business enterprise.

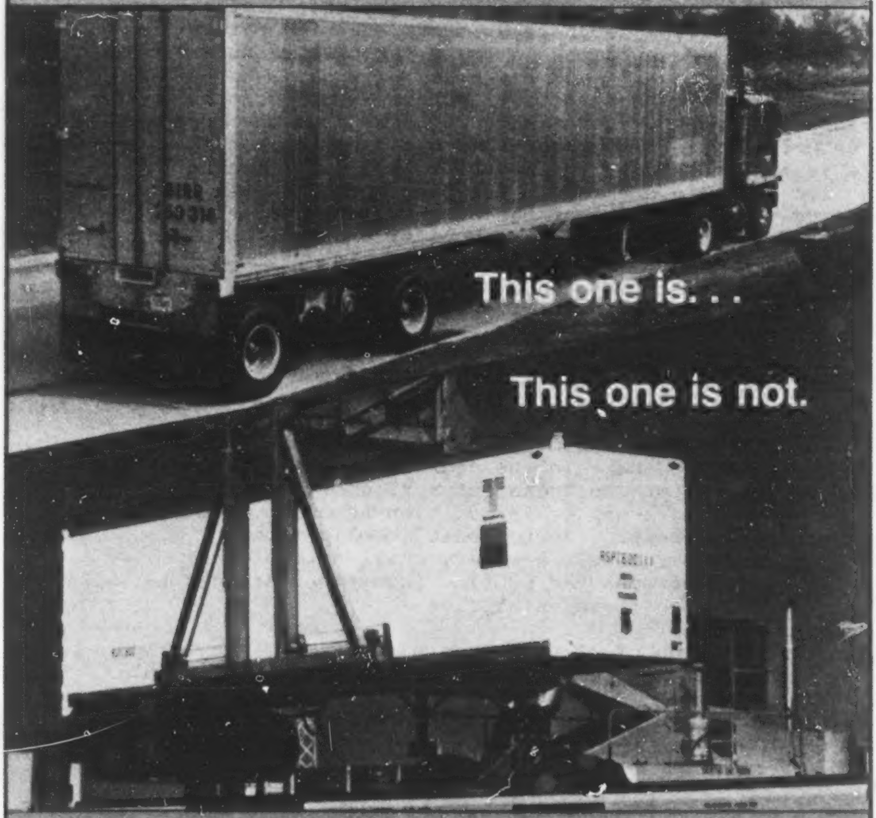
A loan or extension of credit takes many forms. The ruling merely recognizes the fact that repayment of a loan is not necessarily limited to the bank's receipt of principal and a specified amount of interest on a demand or installment basis over time.

Transamerica Interway

EXHIBIT II

THE SURFACE TRANSPORTATION ASSISTANCE ACT OF 1982

Should only one of these be exempt from the Federal Excise Tax?



This one is. . .

This one is not.

These are the facts. . . .

April 1983

Clearly a national bank that purchased SBPDs for its own loan portfolio would not be engaged in dealing in or underwriting securities. The dealing in or underwriting question would only arise if the bank subsequently sold SBPDs to other purchasers. Banks do often buy and sell loans, as an incidental banking power, through the use of loan participations and other vehicles. The Glass-Steagall issue that would have to be addressed in the context of the present discussion is to what extent a national bank can sell a borrower's debt - evidenced by a note, debenture or other debt instrument - without thereby being characterized as engaged in the business of dealing in securities or underwriting an issue of securities. The inquiry focuses on secondary market activity. This Office would not consider the occasional resale of SBPDs by a national bank to another lending institution, perhaps to gain better liquidity in its assets position, as rising to the level of secondary market activity that is proscribed by the Glass-Steagall Act. In any event, the subject of resales goes beyond the question you have posed concerning the authority of national banks to make loans to qualified small businesses by purchasing their nonconvertible debentures.

I trust that this reply is responsive to your inquiry.

Very truly yours,

John G. Heimann
Comptroller of the Currency

The Honorable
Lowell P. Weicker, Jr.
United States Senate
Washington, D.C. 20510

Exhibit IV

AMENDMENT NO. Ex. Calendar No. 40

Purpose: To delete section 5 (a) of the Committee amendment

IN THE SENATE OF THE UNITED STATES— 98th Cong., 1st Sess.

S. 499

H.R. (or Treaty SHORT TITLE)

(title) to require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program.

( ) Referred to the Committee on
and ordered to be printed

( ) Ordered to lie on the table and to be printed

INTENDED to be proposed by Mr. Weicker

Viz:

On page 4, strike all from line 4 through line 13, and insert in lieu thereof "SEC. 5. Section 404(b)(1) of the Small Business Investment".

Exhibit V

089810.171

AMENDMENT NO. ___ Calendar No. ___

Purpose: To modify the provisions relating to subordination.

IN THE SENATE OF THE UNITED STATES--98th Cong., 1st Sess.

S. 499

To require the usage of tax-exempt financing in connection with the Small Business Administration's section 503 loan program.

Referred to the Committee on ______________________________ and ordered to be printed

Ordered to lie on the table and to be printed

Amendments intended to be proposed by Mr.-----------------

Viz:

On page 2, line 22, after ''Sec. 3.'' insert ''(a)''.

On page 3, strike line 7 and insert in lieu thereof the following: ''such obligation, but with respect to any particular project, only if the State or local development company certifies that financing for such project is not available without subordination, and that an alternative means of financing at comparable rates and terms does not exist without financing which includes or is collateralized by an obligation described in section 103 (b) of the Internal Revenue Code of 1954; and''.

On page 3, between lines 13 and 14, insert the following: ''In addition to any charges imposed by the Administration pursuant to subsection (c) of this section, the Administration shall require the small business concern to pay into the revolving fund established pursuant to section 4 (c) (1) (C) of the Small Business Act a one-time fee equal to 1 per centum of the amount of the debenture guaranteed under this section for the financing of a project which includes or is collateralized by an obligation described in section 103 (b) of the Internal Revenue Code of 1954 where the guaranteed debenture is subordinated by the Administration to any such obligation. Such fee shall be available to the Administration solely as a reserve against its losses in connection with such financings.''.

(b) Effective January 1, 1987, section 503 (a) (4) of the Small Business Investment Act of 1958 is amended to read as it read immediately before the enactment of this Act.

At the end of the bill, add the following:

Sec. 6. (a) Section 4 (c) (1) of the Small Business Act is amended--

(1) by striking out ''and'' before ''(B)''; and

(2) by striking out the period at the end and inserting in lieu thereof '', except with respect to the reserve for the Administration's losses in conjunction with financings under section 503 (a) (4) (A) of the Small Business Investment Act of 1958; and (C) a certified development company program fund which shall be available solely as a reserve for the Administration's losses in conjunction with financings under section 503 (a) (4) (A) of the Small Business Investment Act of 1958 for projects which include or are collateralized by obligations described in section 103 (b) of the Internal Revenue Code of 1954 where the guaranteed debenture is subordinated by the Administration to such obligations.''.

(b) Effective January 1, 1987, section 4 (c) of the Small Business Act is amended to read as it read immediately before the enactment of this Act. Unexpended balances in the certified development company program fund shall be transferred into the business loan and investment fund of the Small Business Administration.

Senator PACKWOOD. Lowell, let me say this. Having served with you on the Small Business Committee, I know the record and the foundation you have laid on this. I think the arguments are compelling. I don't think there is a revenue loss; although I know what Treasury's position will be, as they are on many of these bills. I think I can also say with some confidence, we have passed a good many other bills that Treasury doesn't necessarily like.

Senator WEICKER. Thank you very much, Mr. Chairman, for the opportunity to appear before and to work with you again.

Senator PACKWOOD. Thank you very much for coming. We appreciate it.

Just as you finish, I see Senator D'Amato arrive on the scene.

Senator WEICKER. Now if you want to hear operatic eloquence, this is your chance. [Laughter.]

Senator PACKWOOD. Will the record please show that?

STATEMENT OF HON. ALFONSE M. D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Mr. Chairman, thank you so much for affording me the opportunity of testifying on S. 499.

Let me simply suggest that Senator Weicker has been absolutely indispensible in keeping the SBA 503 program operating. The fact is that the program has been incapacitated as the result of OMB's directive prohibiting the use of IDB's in the 503 program. This occurred in the face of a strong congressional intent.

That is why, Mr. Chairman, I introduced S. 499, which would make congressional intent unequivocally clear. IDB's should be used in the 503 program so that small businesses can obtain desperately needed capital for economic development.

Mr. Chairman, I have a long prepared speech, and I'm wondering if I might be able to submit it for the record so that we could get on with other testimony.

Senator PACKWOOD. Of course. Your statement will be in the record in its entirety.

[Senator D'Amato's prepared statement follows:]

STATEMENT BY SENATOR ALFONSE D'AMATO ON S. 499

BEFORE THE FINANCE COMMITTEE

OCTOBER 28, 1983

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO TESTIFY TODAY ON S. 499 AND S. 842. SENATOR WEICKER AND I, IN THE INTEREST OF TIME, HAVE DIVIDED OUR RESPONSIBILITIES. HE WILL PRIMARILY DISCUSS S. 842. I WILL CONCENTRATE MY REMARKS ON S. 499, LEGISLATION TO ASSURE THE USE OF INDUSTRIAL DEVELOPMENT BONDS (IDBs) IN CERTAIN SMALL BUSINESS ADMINISTRATION (SBA) PROGRAMS.

HOWEVER, I WOULD LIKE TO BRIEFLY COMMENT ON S. 842, WHICH WAS INTRODUCED BY THE DISTIGUISHED CHAIRMAN OF THE SMALL BUSINESS COMMITTEE, SENATOR WEICKER. I ECHO HIS SENTIMENTS ON THIS BILL. THE CREATION OF SMALL BUSINESS PARTICIPATING DEBENTURES IS THE LEADING INITIATIVE OF MOST SMALL BUSINESS GROUPS. CLEARLY, THE GREATEST OBSTACLE CONFRONTING SMALL FIRMS IS THE ACQUISITION OF CAPITAL.

WITHOUT THE INFUSION OF REASONABLY PRICED FINANCING, NEW IDEAS SPAWNED BY EMERGING BUSINESSES MAY NEVER BECOME REALITY. THE SMALL BUSINESS COMMUNITY IS THE LINCHPIN OF THE ECONOMY. IF THESE COMPANIES CANNOT RAISE LONG-TERM CAPITAL, THE ECONOMY AS A WHOLE WILL SUFFER. THE CREATION OF SMALL BUSINESS PARTICIPATING DEBENTURES WILL GUARANTEE THE AVAILABILITY OF VENTURE CAPITAL. I AM PROUD TO BE A COSPONSOR OF S. 842 AND I SUPPORT SENATOR WEICKER IN HIS EFFORTS TO ENACT THIS LEGISLATION.

TURNING TO THE OTHER LEGISLATION WE ARE ADDRESSING, MR. CHAIRMAN, S. 499 BECAME NECESSARY BECAUSE OF OMB'S ATTEMPT TO PROHIBIT THE USE OF IDBs IN THE SBA SECTION 503 AND SECTION 404(B) PROGRAMS. THE OMB ERRONEOUSLY CONTENDS THAT IDBs ARE A GOVERNMENT HANDOUT, WHICH ACCOMPLISH NOTHING THAT WOULD NOT OTHERWISE BE ACCOMPLISHED BY THE PRIVATE SECTOR. THE OMB CONTENDS THAT IDBs USED IN CONJUNCTION WITH SBA'S DEVELOPMENT PROGRAMS CREATE NO ADDITIONAL JOBS, SPUR NO

ADDITIONAL ECONOMIC DEVELOPMENT, AND BRING NO ADDITIONAL PROJECTS TO FRUITION. MR. CHAIRMAN, THE OMB IS WRONG.

FOR THIS SPECIOUS REASON, HOWEVER, THE SBA, AT THE SPECIFIC INSTRUCTION OF THE OMB, CIRCUMVENTED CLEARLY SPELLED OUT CONGRESSIONAL INTENT AND DENIED THE USE OF IDBs IN THESE SBA PROGRAMS. I WILL COMMENT ONLY ON THE LEGISLATION AS IT PERTAINS TO THE 503 PROGRAM. SENATOR LEVIN WILL ADDRESS THE 404(B) POLLUTION CONTROL PROGRAM.

THE SBA 503 CERTIFIED DEVELOPMENT COMPANY PROGRAM WAS ESTABLISHED ON JULY 2, 1980, AS A MEANS OF FOSTERING LOCAL ECONOMIC DEVELOPMENT. THIS PROGRAM IS INTENDED TO ENCOURAGE SMALL BUSINESSES TO UNDERTAKE COMMUNITY DEVELOPMENT PROJECTS WHICH WILL INCREASE EMPLOYMENT. THE 503 PROGRAM BRINGS TOGETHER SMALL BUSINESS, LOCAL GOVERNMENT, AND THE SBA TO FINANCE WORTHWHILE LOCAL VENTURES.

SECTION 503 OF THE SMALL BUSINESS INVESTMENT ACT CALLS FOR THE SBA TO LEVERAGE ITS GUARANTEED DEBENTURES AS A STIMULUS FOR PRIVATE INVESTMENT. GENERALLY SBA PROVIDES 40%

OF THE FINANCING IN A PROJECT, PRIVATE SOURCES SUPPLY ANOTHER 50%, AND THE PARTICIPATING SMALL BUSINESS INFUSES THE REMAINING 10%. THE SBA GUARANTEE OFFERS SUFFICIENT COMFORT TO LENDERS TO ENCOURAGE THEIR PARTICIPATION. IN MOST CASES, THE AFFECTED SMALL BUSINESS COULD NOT OBTAIN PRIVATE FUNDING AT COST EFFECTIVE RATES. AS YOU KNOW, MANY WORTHWHILE ENDEAVORS ARE ABANDONED FOR REASONS OTHER THAN PROJECT VIABILITY.

SECTION 503 AUTHORIZES THE SBA TO GUARANTEE DEBENTURES ISSUED BY CERTIFIED DEVELOPMENT COMPANIES (CDC's) TO ASSIST IN THE FUNDING OF WORTHY PROJECTS. ONLY THE PURCHASE OF NEW PLANT AND EQUIPMENT MAY BE FINANCED UNDER THE 503 PROGRAM; WORKING CAPITAL CAN NOT BE AUGMENTED. THE LIFE OF THE LOANS ARE GENERALLY FROM FIVE TO TWENTY-FIVE YEARS AND THE SBA MAY ONLY PARTICIPATE UP TO A $500,000 MAXIMUM IN ANY ONE PROJECT.

SBA BEGAN CERTIFYING CDCs IN LATE 1980. AT THE END OF FISCAL YEAR 1983, 33,618 DOCUMENTED JOBS HAD BEEN CREATED

WITH AN AVERAGE SBA INVESTMENT PER JOB OF ONLY $5,083. THIS REPRESENTS 904 GUARANTEES MADE BY SBA WITH A TOTAL VALUE OF $170.9 MILLION.

DESPITE THE FORMIDABLE FIGURES RELATING TO JOB CREATION IN THE 503 PROGRAM, OMB HAS FORBIDDEN THE SBA FROM OFFERING ITS GUARANTEE TO ANY 503 PROJECT UTILIZING IDBs. THIS IS CLEARLY CONTRARY TO EXPRESSED CONGRESSIONAL MANDATE STIPULATED WHEN 503 WAS CONCEIVED. ALLOW ME TO QUOTE DIRECTLY FROM THE CONFERENCE REPORT ESTABLISHING THE 503 PROGRAM:

> "SBA SHOULD NOT DISAPPROVE THE GUARANTEE OF ANY DEBENTURE, OR ANY LOAN MADE WITH THE PROCEEDS OF A DEBENTURE ISSUE, SOLELY BECAUSE THE PROCEEDS WOULD BE USED IN A PROJECT WHOSE OTHER SOURCES OF FINANCING INCLUDE, OR ARE COLLATERALIZED BY, INDUSTRIAL REVENUE OR DEVELOPMENT BONDS."

CONGRESSIONAL INTENT WAS UNEQUIVICAL; IDBs AND SBA GUARANTEED DEBENTURES ARE NOT MUTUALLY EXCLUSIVE FINANCING VEHICLES.

WE HAVE TWO IMPORTANT ISSUES TO CONSIDER: CLEAR CONTRADICTION OF CONGRESSIONAL AUTHORITY BY THE EXECUTIVE BRANCH AND THE CONCOMITANT DETERIORATION OF 503 GUARANTEE ACTIVITY. OBVIOUSLY, WE SHOULD NOT ALLOW CONGRESSIONAL INTENT TO BE SO RUDELY CAST ASIDE. ALSO, AND IN SOME WAYS MORE IMPORTANTLY, THE USE OF IDBs IN THE 503 PROGRAM, AS MANDATED BY CONGRESS IN THE EMERGENCY JOBS BILL, ENDED ON SEPTEMBER 30, 1983. THE RESULT IS THAT AMERICA'S ECONOMY IS THAT MUCH WORSE OFF.

THE PROVISIONS OF S. 499 WILL FOSTER THE USE OF IDBs IN SECTION 503 LOANS AS ORIGINALLY INTENDED BY CONGRESS. AT THIS STAGE OF OUR ECONOMIC RECOVERY, IT IS OF PARAMOUNT IMPORTANCE THAT ECONOMIC DEVELOPMENT BE ENCOURAGED. THE SBA SECTION 503 PROGRAM ALLOWS SMALL BUSINESSES TO PLAY A ROLE IN SUCH ECONOMIC DEVELOPMENT.

MR. CHAIRMAN, SINCE BEING INTRODUCED ON FEBRUARY 16, 1983, S. 499 HAS HAD AN INTERESTING LEGISLATIVE HISTORY. THE SMALL BUSINESS COMMITTEE UNANIMOUSLY REPORTED OUT THE LEGISLATION BY A VOTE OF 16 TO 0. THE FINANCE COMMITTEE STAFF RAISED AN OBJECTION TO SOME OF THE LANGUAGE ADDED IN MARKUP TO S. 499. THE LANGUAGE IN QUESTION WAS STRICKEN. ON THE SENATE FLOOR, SENATOR METZENBAUM RAISED AN OBJECTION TO S. 499, AND THE BILL HAD TO BE PULLED FROM CONSIDERATION. I AM PLEASED TO SAY, THAT A COMPROMISE HAS BEEN REACHED WITH SENATOR METZENBAUM.

NOW, A NEW THREAT TO S. 499 HAS BEEN PRESENTED BY THE WAYS AND MEANS COMMITTEE. AS YOU KNOW, MR. CHAIRMAN, THE COMMITTEE HAS PROPOSED MAJOR RESTRICTIONS ON THE USE OF IDBs. TERMING THE WAYS AND MEANS ACTIONS AS "MAJOR RESTRICTIONS" IS BEING TOO GENEROUS. IN EFFECT, THE COMMITTEE HAS DESTROYED THE ECONOMIC USEFULLNESS OF IDBs.

MANY OF THE PROVISIONS IN THE WAYS AND MEANS BILL ARE A DIRECT ASSAULT ON SMALL BUSINESS INTERESTS, WHICH INCLUDE THE FOLLOWING:

1) A STATE BY STATE $150 PER CAPITA VOLUME CAP ON THE USE OF IDBS. ACCORDING TO TREASURY DEPARTMENT STATISTICS, WHICH ARE OF DUBIOUS QUALITY, FOR THE FIRST HALF OF 1983, 15 STATES EXCEEDED THE VOLUME CAP. OF COURSE, SINCE IDB VOLUME IS DOWN IN 1983-- DUE TO A LATE 1982 "RUSH TO MARKET" PRIOR TO THE IMPLEMENTATION OF THE TEFRA RESTRICTIONS-- OTHER STATES WILL NO DOUBT ALSO EXCEED THE THRESHOLD IN THE FUTURE. THESE STATES WILL HAVE TO CHOOSE WHO SHOULD, AND SHOULD NOT, UTILIZE IDB FINANCING. IN ALL LIKLIHOOD, SMALL FIRMS WOULD BE THE FIRST CUT OUT OF THE PROGRAM.

2) THE ARBITRAGE RULES FOR MORTGAGE REVENUE BONDS, FOR THE FIRST TIME, WOULD APPLY TO IDBs. THIS WOULD LIMIT ARBITRAGE INCOME TO NO MORE THAN 1 1/8% OVER

THE STATED INTEREST RATE ON THE BONDS. THIS PROVISION WILL ONLY HURT SMALL ISSUE IDBs. SMALL COMPANIES WILL NOT BE ABLE TO ABSORB THE INCREASED COSTS ASSOCIATED WITH A BOND ISSUANCE THAT ARE USUALLY COVERED THROUGH ARBITRAGE.

3) A PROHIBITION AGAINST THE PURCHASE OF STRUCTURES WITH THE PROCEEDS OF IDBs. IN A DEVELOPED STATE SUCH AS NEW YORK, THE PURCHASE OF EXISTING STRUCTURES, FREQUENTLY ABANDONED DUE TO PLANT CLOSURES, IS CRITICAL TO ECONOMIC DEVELOPMENT. FOR MOST SMALL FIRMS, THE COSTS OF PURCHASING AN EXISTING STRUCTURE CAN BE UNDERTAKEN ONLY IF REASONABLY PRICED FINANCING IS OBTAINED. WITHOUT THE AVAILABILITY OF IDBs, SMALL FIRMS WOULD NOT EXPAND INTO AN EXISTING STRUCTURE OR ENTER A COMMUNITY WHICH MAY HAVE LOST ITS ONLY MAJOR EMPLOYER.

FINALLY, WAYS AND MEANS INCLUDED A PROVISION THAT WOULD DISALLOW THE TAX-EXEMPT STATUS OF IDBs IF THERE IS AN INDIRECT OR DIRECT FEDERAL GUARANTEE INVOLVED. THE SBA HAS INFORMED ME THAT THIS PROVISION WOULD EFFECTIVELY TERMINATE THE USE OF IDBs IN THE 503 PROGRAM. WAYS AND MEANS HAS DECIDED TO STIFLE ECONOMIC DEVELOPMENT BY KILLING S. 499, EVEN PRIOR TO ITS ENACTMENT.

MR. CHAIRMAN, IDBs ARE NECESSARY TO FOSTER ECONOMIC DEVELOPMENT. MY BILL, S. 499, WOULD UTILIZE IDBs IN THE SBA 503 PROGRAM AS MANDATED BY CONGRESS. THIS IS NOT AN ABUSE. THE PROGRAM IS A LEGITIMATE MEANS OF IMPROVING ECONOMIC DEVELOPMENT. UNFORTUNATELY, ACTIONS IN THE HOUSE HAVE SET BACK THE CAUSE OF ECONOMIC DEVELOPMENT THOUGHOUT THE NATION.

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO TESTIFY, AND I WOULD BE PLEASED TO ANSWER ANY QUESTIONS.

Senator D'AMATO. Let me commend you, Mr. Chairman, for holding these hearings so that we can really look at what I think are the benefits that accrue to small business and to our economy.

This is not the time to do away with the industrial revenue bonds, particularly as it relates to the small businesses which so desperately need it. They don't borrow at prime rate—they borrow at prime rate plus.

I would suggest to those who are attempting cost cutting that there are different manners by which we can undertake that cost containment. This is not going to be the elimination of the 503 program, a prudent fiscal investment. I think industrial revenue bonds are a prudent fiscal investment, particularly as it relates to the small business and the small business community. If there are abuses, I challenge the Ways and Means Committee and even our own Senate Finance Committee to deal with the particular abuses, but not to just simply sever these programs.

That's why S. 842 and S. 499 are so particularly important.

I thank the chairman for his courtesy.

Senator PACKWOOD. I might say, in addition to your argument, I am further persuaded by the fact that I have received a letter from the Governor of the State of Oregon specifically endorsing your bill. I am submitting it for record.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you very much.

[The letter from the Governor of Oregon follows:]

VICTOR ATIYEH
GOVERNOR

OFFICE OF THE GOVERNOR
STATE CAPITOL
SALEM, OREGON 97310

1983 NOV -7 AM 12:31

October 27, 1983

The Honorable Bob Packwood
U.S. Senate
259 Russell - Senate Office Building
Washington, D.C. 20510

Dear Bob:

It has come to my attention that Senate Bill 499 is presently under consideration in the Finance Committee. The bill would allow continued use of industrial development revenue bonds in conjunction with Small Business Administration Certified Development Corporation ("503") financing. This is an important bill for Oregon and I encourage you to support it.

This year, the state Legislature passed by a overwhelming margin and I signed into law, a bill authorizing a new Umbrella Revenue Bond program. The program makes revenue bonds available for smaller projects (approximately $100,000 to $1 million) that had not previously been economically feasible. The projects financed by these bonds will generally be for small businesses in conjunction with the SBA 503 program. Oregon's Umbrella Revenue Bond program will allow these smaller businesses access to the same revenue bond market to which firms with larger projects have access. Combining Industrial Revenue Bonds with SBA 503 financing can create a package that is affordable, while without the combination, the expansion would not be undertaken.

Our goal is to create new jobs and expand Oregon's economy and it is the small businesses that create a majority of the jobs. I see the need on a daily basis for affordable long-term financing for Oregon business and businesses looking to locate in Oregon. I strongly urge your support for Senate Bill 499.

Sincerely,

Victor Atiyeh
Governor

VA:mh

Senator **Packwood**. I don't see Senator Levin. I don't see Senator Specter, and I don't see Congressman Eckart. So let's take Robert Woodward, the Tax Legislative Counsel for the Department of the Treasury.

Mr. Woodward, I may interrupt you for one of the Senators or Congressmen when they come in.

As usual, your entire statement will be in the record, and to the extent you can abbreviate it, I would appreciate it.

STATEMENT OF ROBERT WOODWARD, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. **Woodward**. Thank you, Mr. Chairman.

I am pleased to present the views of the Treasury Department on the bills before your subcommittee this morning.

The first bill I will discuss is S. 499, which would require direct or indirect Federal guarantees of tax-exempt obligations under the Small Business Administration section 503 development company program, and the SBA pollution control financing guarantee program. The administration opposes this bill.

Under the SBA pollution control financing program, SBA has authority to guarantee 100 percent of payments due under loan agreements, leases, or other contracts entered into by small businesses to acquire pollution control equipment.

Before 1982, State and local governmental bodies issued tax-exempt IDB's that could be secured by SBA-guaranteed agreements under which small businesses acquire pollution control equipment. Thus, tax-exempt IDB's were secured by federally guaranteed collateral, creating a security as desirable as if SBA had guaranteed the bonds directly. Because of the general policy against federally guaranteed tax-exempt bonds, since the beginning of 1982, SBA has issued its guarantees only in connection with taxable pollution control financings.

SBA section 503 projects, which involve financing of land, plant, and equipment for small businesses, are joint financing ventures that are financed with a combination of SBA-guaranteed debentures and other obligations which are not guaranteed by the SBA. We understand that no fee is charged by the SBA for guaranteeing the debentures.

In a typical transaction, the SBA-guaranteed debentures are issued by a development company which acts as an intermediary between the sources of capital and a small business, and are sold to the Federal Financing Bank. The debenture or a loan made with the proceeds of the debenture is subordinated to outside financing of the business.

Some of the projects eligible for the section 503 loan program could be financed in part with tax-exempt small issue IDB's, and the debentures guaranteed by the SBA could be subordinated to the tax-exempt IDB's in the event of default. In such a case, the SBA probably would be forced, in effect, to pay off the tax-exempt financing in order to protect its junior position with respect to the financed property.

The SBA has viewed such arrangements as an indirect guarantee of the IDB's, and since September 30, 1983, has declined to guarantee or participate in section 503 loans for projects in which tax-exempt financing is used, unless the SBA guarantees debentures on a parity with or has a lien superior to the tax-exempt financing.

S. 499 would prohibit SBA from declining to guarantee obligations or to subordinate its guaranteed obligations or loans made with the proceeds of those obligations, merely because tax-exempt financing——

Senator **Packwood**. Mr. Woodward, we would appreciate it if you wouldn't read your entire statment.

Mr. **Woodward**. I don't intend to, Senator.

We have strong policy objections against Federal guarantees for tax-exempt securities. Guaranteeing a tax exempt creates a security that is superior in the market to direct Treasury obligations. It also creates a security that has a distinct competitive advantage over GO obligations of State and local governments. There is a longstanding policy reflected in the Public Debt Act and other legislative enactments against Federal guarantees of tax exempts.

We also think that both the tax exemption and the guarantee is an unnecessary duplication of Federal subsidies, particularly during times of budgetary constraint.

There are a number of other arguments that we make in the written statement against the use of Federal guarantees in connection with tax-exempt financing. We believe that an appropriate response in this area is reflected in a bill, S. 1061, which was introduced by Senator Dole on behalf of the administration in a slightly different context. That bill is designed to deny tax-exempt status to obligations backed by Federal deposit insurance provided by FDIC or FSLIC. Conceptually, that arrangement is essentially the same as the SBA guarantee, except the SBA guarantee is a stronger guarantee even than that of FDIC or FSLIC.

For those reasons, the administration opposes S. 499.

Next, I will discuss two bills together, S. 831 and S. 1914.

Both of these bills deal with tax incentives for individuals who have attained age 55 and wish to convert equity they have invested in their homes into cash while they continue to reside in their homes.

The Treasury supports the amendment to code section 121 that would be made by these bills; however, we oppose the other changes proposed by the bills because we believe they would provide inappropriate tax benefits to investors.

The bills are quite detailed. Our statement goes at some length to discuss the reasons we oppose the provisions other than the amendment to section 121.

If you would like, I could go into that analysis, but the bottom line of that is that there are a number of changes that would be made. We believe that they primarily would redound to the benefit of the tax shelter investors in these homes.

Senator **Packwood**. Let me ask you this: Do you like the concept of trying to keep people in their declining years in their homes?

Mr. **Woodward**. We certainly have no objection to that concept. Indeed, the section 121 amendment would clarify existing law to make it certain that a homeowner would be able to sell a remainder interest, retaining a life estate—the right to occupy the home for life—without any tax problem under section 121.

The rest of the provisions of these bills, however, are designed to shift depreciation deductions to tax-shelter investors who are having either no income from the property because there is no rent being paid, in the case of S. 831, or a below fair-market value rent, as in the case of S. 1914. We think this creates some distortions to which we have objections. We think this is somewhat analagous to the sale and leaseback transactions involving municipal property which have been the subject of legislation before the Senate Finance Committee recently. And we think that, while the elderly homeowner is not a nontaxable person, he certainly would typically be in a lower tax bracket than the investor who would be buying—the wealthy doctor or what have you who would be buying the home and attempting to obtain depreciation deductions and the hope of future capital appreciation.

We understand, indeed, that there are some groups representing the elderly who have some problems with this bill, in that they have concerns about the types of transactions which would be promoted under this mechanism. I think that whether or not the bills would really benefit the elderly is not something that we are in a position to comment on. But there is concern that the tax-motivated investors and those who are promoting those types of investments might be able to take unfair advantage of elderly homeowners in many cases. I don't think that this concern really enters into our analysis of the tax aspects of the bills, but I think it does relate to considerations which would be significant to this committee.

The next bill is S. 842, which Senator Weicker has testified about. We oppose this bill, as you know. The revenue loss associated with the bill, which we estimate will be approximately $3 billion through 1988, is unacceptable. There have been a lot of changes in the Tax Code recently to assist all businesses, including small businesses, in the Economic Recovery Tax Act, primarily.

In addition, the Subchapter S Revision Act of 1982 alleviated the burden of double taxation on small business corporations. We believe that those changes are sufficient.

We also have serious tax policy objections to the bill. It would authorize a security that combines the best features of debt securities and equity investments without the concomitant detriments of either. It would, in fact, provide better tax treatment than is available to either debt or equity investments, in many cases.

For example, issuers of SBPD's would be allowed to deduct as interest the amount paid to holders, which represents a distribution of corporate profits, notwithstanding the fact that present law does not permit corporations to deduct dividends or amounts paid to redeem stock. And holders of SBPD's would receive capital gain treatment with respect to those distributions. We certainly think that consistency requires that if there is a deduction at the payor level, there be ordinary income at the recipient level. We don't see any justification for the different treatment here. We much prefer, in designing tax incentives, that they not be narrowly targeted to particular industry groups. Rather, we prefer across-the-board changes that don't result in the economic distortions that would result from this bill. This bill would create a clear incentive—we would consider it a distortion—channel investments into the types of businesses that would qualifty to issue this tax-favored security.

Senator **Packwood**. Let me ask you this: If this committee decided that it wanted to tilt in the direction of small business, would this particular bill achieve that?

Mr. **Woodward**. I think that we at the Treasury Department would have other types of changes that we would prefer to be made, in the nature of assisting small business.

I note in my testimony that we have done a lot of that already—we have the expensing provision that was part of the ACRS changes, which was a small business oriented provision. I think the lowering of tax rates generally is something that small businesses certainly benefit from uniformly, whether or not they are in the market for borrowing capital or not.

You would have to realize that there are certainly a lot of small businesses which may be operating on equity capital. This bill deals with only one category of small businesses to the exclusion, perhaps, of other small businesses which may not want to incur the risk of going into the capital market to make leveraged investments.

If the committee is interested in assisting small businesses, though, I think that we certainly would want to work with you to see what other alternatives might achieve the results you desire, with less problems for us.

The next bill I will discuss is S. 1231, which would provide an exemption for piggyback trailers and semitrailers from the 12-percent sales tax on heavy trucks and trailers.

Treasury opposes this bill, as does the Department of Transportation.

The proponents of the bill argue that piggybacks should be exempted from tax because they generally travel less than 3,000 miles per year on the highways and thus do not contribute much to highway damage. We don't have sufficient data to prove or disprove that allegation, but there is some question that has been raised about it at the Department of Transportation.

Senator **Packwood**. Let me ask you this: If that data were true, would you support the bill?

Mr. **Woodward**. Mr. Chairman, I think that you would have to raise a question of at what point in time the data is determined. A major concern here is what the behavioral response would be to this exemption.

We think that piggyback trailers, if exempted from the 12-percent sales tax, could be used as over-the-road vehicles—it would be economically feasible to do so.

Senator **Packwood**. Well, I understand that.

Mr. **Woodward**. But they would be substituted for regular trailers.

Senator **Packwood**. We exempt road railers because the presume that they are going to be used most of the time off road.

Mr. **Woodward**. That is correct.

Senator **Packwood**. And all I am saying is, if the facts indicated that the piggybacks were going to be used 95 percent of the time off the road, you could justify treating them like road railers. Your question really is one of fact.

Mr. **Woodward**. Yes, Mr. Chairman. That is the question. I think that the experts at the Department of Transportation believe there would be a substitution although it's somewhat difficult to make those kinds of determinations. But that essentially is the basis for not excluding those from the tax in the original bill.

Senator PACKWOOD. All right. Let's move on to 1807.

Mr. WOODWARD. The last bill is S. 1807. It would provide that dividends received by controlled foreign corporations are excluded from the recipient's subpart F income, where the dividends are paid out of income derived from certain agricultural commodities. The Treasury also opposes this bill.

The controlled foreign corporation provisions of the code were enacted generally to eliminate tax deferral with respect to income of U.S.-controlled foreign corporations where the income was derived from transactions with related persons and did not otherwise originate in the foreign country of incorporation. Thus, as a general rule, dividends received by a CFC are treated as subpart F income.

This bill would create an exception to that rule. We do not believe that there is a compelling basis for making that exception in this case, and therefore we oppose this bill.

Senator PACKWOOD. Let me ask this question:

If Consolidated Foods, operating through its first-tier subsidiary, has income from food not grown in commercial quantities overseas, it's exempt from taxation?

Mr. WOODWARD. That is correct, Mr. Chairman.

Senator PACKWOOD. So why should it be subject to tax if it is a second-tier corporation?

Mr. WOODWARD. There are many circumstances in which income generated by one corporation within an affiliated group is not itself subpart F income, but becomes subpart F income when shifted around within that group in the form of dividends. And the mere fact that there would be an exemption had the dividend-receiving corporation conducted the activity itself is generally not sufficient grounds for the exemption under the whole theory of the subpart F rules.

Senator PACKWOOD. After your statement I will insert a statement from Senator Percy in support of this bill. Mr. Woodward, I have no more questions.

Mr. WOODWARD. Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you.

[Mr. Woodward's statement and Senator Percy's statement follow:]

For Release Upon Delivery
Expected at 9:30 a.m. EDT
October 28, 1983

STATEMENT OF
ROBERT G. WOODWARD
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on the following bills:

> S. 499, which would require the usage of tax-exempt financing in connection with loan guarantee programs of the Small Business Administration;
>
> S. 831 and S. 1914, which would provide special rules for the tax treatment of "home equity conversions" in which a homeowner sells his or her principal residence while retaining the right of occupancy;
>
> S. 842, which would provide tax incentives for the issuance of small business participating debentures;
>
> S. 1231, which would exempt certain piggyback trailers and semitrailers from the excise tax on heavy trucks and trailers; and
>
> S. 1807, which would provide an exclusion from subpart F income for certain dividends paid from agricultural commodities income of foreign corporations.

I will discuss each of these bills in turn.

S. 499

Use of Tax-Exempt Financing in Connection with SBA Loan Programs

S. 499 would require direct or indirect Federal guarantees of tax-exempt obligations under the Small Business Administration ("SBA") section 503 development company program and the SBA pollution control financing guarantee program. The Administration strongly opposes S. 499.

Background

Under present law, State and local obligations that are used in a private trade or business and that are classified as industrial development bonds ("IDBs") qualify for tax-exempt status if they are used for certain enumerated purposes. One such purpose is for air and water pollution control facilities. In addition, tax-exempt "small issue" IDBs may be issued for the acquisition or improvement of land or depreciable property (with several exceptions).

Under the SBA pollution control financing guarantee program, SBA has authority to guarantee 100 percent of the payments due under loan agreements, leases, or certain other contracts entered into by small businesses, to acquire pollution control equipment. Before 1982, State and local governmental bodies issued tax-exempt IDBs that were secured by SBA-guaranteed agreements under which small businesses acquired pollution control equipment. Thus, tax-exempt IDBs were secured by Federally guaranteed collateral, creating a security as desirable as if SBA had guaranteed the bonds directly. Because of the general policy against Federally guaranteed tax-exempt bonds, since January 1, 1982, SBA has issued its guarantees only in connection with taxable pollution control financings.

SBA section 503 projects, which involve financing of land, plant and equipment for small businesses, are joint financing ventures that are financed with a combination of SBA-guaranteed debentures and other obligations which are not directly guaranteed by the SBA. We understand that no fee is charged for the SBA guarantee of the debentures. In a typical transaction, the SBA-guaranteed debentures are issued by a development company, which acts as an intermediary between the sources of capital and the small business, and are sold to the Federal Financing Bank. The debenture (or a loan made with the proceeds of the debenture) is subordinated to the outside financing of the business. Some of the projects eligible for the section 503 loan program could be financed in part with tax-exempt small issue IDBs, and the debentures guaranteed by the SBA could be subordinated to the tax-exempt IDBs in the event of default. In such a case, the SBA probably would be forced in effect to guarantee the tax-exempt financing in order to protect its junior position with respect to the financed property. The SBA has viewed such arrangements as an indirect guarantee of the IDBs, and since September 30, 1983 has declined to guarantee or participate in section 503 loans for projects in which tax-exempt financing is used, unless the SBA-guaranteed debentures are on a parity with (or have a lien superior to) the tax-exempt financing.

Description of S. 499

S. 499 would prohibit SBA from declining to guarantee obligations or to subordinate its guaranteed obligations (or loans made with the proceeds of those obligations) merely because tax-exempt financing is used for projects qualifying under either the pollution control or section 503 programs.

Discussion

The Administration opposes this bill for several reasons.

Placing the credit of the United States behind a tax-exempt obligation creates a security which, because of the tax exemption, is superior in the market to direct obligations issued by the Federal government. A Federally guaranteed tax-exempt obligation, because it has no risk of nonpayment, also has a distinct competitive advantage over all other tax-exempt obligations issued by State and local governments. As a result, Federal guarantees of tax-exempt IDBs increase the borrowing costs of Federal, State and local governments. Because of these and other considerations, there is a long-standing Federal policy against Federal guarantees (direct or indirect) of tax-exempt obligations. Reflecting this policy, the Public Debt Act of 1941 prohibits the Federal government from issuing tax-exempt obligations directly. In numerous other statutes, Congress has precluded Federal guarantees of tax-exempts in other contexts.

In addition, Federal guarantees of tax-exempt securities add a second implicit subsidy to the substantial subsidy already created by the tax-exemption of the interest paid. A Federal guarantee reduces the risk premium incorporated in the interest rate charged to the borrower. The implicit subsidy is the cost to the Federal government of the guaranteed projects that default over the fees paid for the guarantee. In the SBA section 503 program, no fee is charged for the guarantee. Once granted, the subsidies are uncontrollable for the life of the guaranteed obligations. In these times of budgetary constraint, we believe that the doubling up of Federal benefits (the Federal guarantee plus the tax exemption of the bond interest) for a single project is unwarranted.

These arguments against Federal guarantees of tax-exempt obligations apply regardless of whether the Federal guarantee is direct or indirect. Under the SBA section 503 program, subordination of the Federal government's security interest to the security interests of the holders of the tax-exempt obligations would give the holders of the tax-exempt securities preferred status in the event of a default. The tax-exempt obligations would be paid in full before there would be any payment on the subordinated obligations guaranteed by SBA. SBA would be taking most, if not all, of the credit risk of the business, and the holders of the tax-exempt securities thus effectively would be guaranteed by the Government.

There are several additional reasons that we oppose Federally guaranteed tax-exempt bonds. Tax exemption of interest is an inefficient means of providing Federal assistance. The revenue loss to the Treasury from the use of IDB financing significantly exceeds the interest savings to the users of IDB proceeds. In the case of long-term tax-exempt bonds, one-third or more of the benefit of tax-exempt financing generally is captured by the financial institutions and other investors who hold the bonds, rather than by the intended beneficiaries. Adding a Federal guarantee to these bonds will increase their popularity and thus exacerbate the loss caused by the inefficiency of the bonds.

It is often argued that Federal assistance for construction of pollution control facilities is justified because pollution control requirements are special burdens imposed on businesses by government. However, in our view the cost of controlling pollution should be regarded as part of the cost of producing goods and should be reflected in market prices. The consumption of goods produced by techniques that create air or water pollution as a by-product will be excessive if the market prices of those goods do not reflect all production costs. Thus, providing tax-exempt financing or Federal guarantees (at below cost) for investments in pollution control facilities produces a higher level of investment in polluting industries and a lower level of investment in other economic activities. Another result of the subsidy is that part of the cost of controlling pollution is borne by taxpayers in general, rather than by the purchasers of the goods produced.

Federal subsidies for pollution control facilities also have been justified in the past by the need to assist businesses in bringing existing plants into compliance with new pollution control requirements. Now, however, most pollution control bonds are issued to finance facilities for new plants rather than existing plants. Thus, the "transition rule" argument for Federal assistance is no longer applicable in the majority of cases. Furthermore, it is difficult in many cases to determine what portion of a newly constructed plant constitutes pollution control facilities, particularly if the plant employs new or innovative processes or equipment rather than facilities of a type that previously have been recognized as qualifying for tax-exempt financing. This inevitably creates an undesirable bias against new technology and in favor of particular types of pollution control equipment which are recognized as eligible for tax-exempt financing. Adding a Federal guarantee to tax-exempt pollution control bonds exacerbates these problems.

Some people have argued that tax-exempt financing for small businesses creates new jobs and economic activity, and, to the extent that Federally guaranteed tax-exempt bonds (such as indirectly guaranteed bonds under the SBA section 503 program) are more attractive than bonds that are not guaranteed, they will produce even more jobs. We believe that this argument is not correct for several reasons. While this argument may be correct for a particular business or segment of the economy, it does not hold for the entire economy. If the funds were not spent on the tax-exempt bond financed project, they would have been invested elsewhere in the economy. Shifting these funds to a tax-exempt financed project creates a offsetting loss of investment and employment in unsubsidized sectors of the economy. Furthermore, even if there were a net increase in employment, that benefit to the economy would be offset by the inefficiency of the misallocation of resources caused by the narrow tax exemption. General tax cuts are a much better means of creating economic incentives, since they avoid the distortions caused by narrowly targeted benefits.

We believe that an appropriate response by Congress to the problem of Federally guaranteed tax-exempt bonds is to provide that obligations directly or indirectly guaranteed by the Federal government generally will be ineligible for tax-exempt status. This would be consistent with the approach of S. 1061, a bill introduced by Senator Dole on behalf of the Administration to deny tax-exempt status to obligations backed by Federal deposit insurance provided by FDIC or FSLIC. It should be noted that Section 722 of H.R. 4170 (the Tax Reform Act of 1983), as reported on October 21 by the House Ways and Means Committee, expands upon the approach of the FDIC/FSLIC legislation by denying tax-exempt status to a wide variety of Federally guaranteed obligations. Since S. 499 would move in the opposite direction by increasing the use of Federally guaranteed tax-exempt bonds, the Administration strongly opposes the bill.

S. 831 and S. 1914
Home Equity Conversions by Individuals Who Have Attained Age 55

Although S. 831 and S. 1914 differ in scope, both bills would provide tax incentives for individuals who have attained age 55 to convert equity they have invested in their homes into cash, while they continue to reside in their homes. The Treasury Department supports the amendment to Internal Revenue Code Section 121 made by these bills. However, we must oppose the other changes proposed by the bills because we believe that they would provide inappropriate tax benefits to investors.

Background

S. 831 is intended to amend the Internal Revenue Code to promote home equity conversions through sale-life tenancy arrangements. A homeowner would be able to use a sale-life tenancy arrangement as a device to convert his home equity into current cash, while he continues to reside in the home, by selling the home in a transaction in which he retains a life estate in the property. In effect, therefore, the homeowner would sell only the remainder interest in the property and would continue to reside in the home, without any obligation to pay rent, pursuant to the retained life estate.

The division of real property into life estates and remainder interests is in some respects recognized by the Internal Revenue Code. Section 167(h) of the Code, for example, has provided since 1928 that the depreciation deduction must be computed as if the life tenant were the absolute owner of the property. Thus, the holder of a remainder interest in depreciable property is not entitled under present law to claim any depreciation. At the time that the life tenant dies and the remainderman takes possession of the property, however, the remainderman is permitted to claim depreciation with respect to his basis in the property.

The provisions of section 121, which are intended to provide a one-time exclusion from gross income for a portion of the gain realized from the sale of a residence, do not explicitly recognize the division of a fee simple interest into a life tenancy and a remainder interest. Section 121 provides only that "gross income does not include gain from the sale or exchange of property," if the property has been owned and used by the taxpayer as his principal residence for three of the five years preceding the sale. Under section 121, it is not clear whether gain from the sale of a remainder interest in a residence can qualify for the exclusion.

The tax treatment of the seller of a remainder interest was considered by the Internal Revenue Service in Rev. Rul. 77-413, 1977-2 C.B. 298. The ruling held that the sale of real property by a taxpayer who retained a right of use and occupancy constituted a sale of only a remainder interest, rather than a sale of the entire interest for an amount equal to the sum of the purchase price and the value of the retained interest. Accordingly, the amount realized by the seller did not include the value of the retained possessory interest in the property. The ruling did not consider the applicability of section 121 to the sale.

A more sophisticated form of home equity conversion may be accomplished by a sale-leaseback transaction. A traditional sale-leaseback transaction would involve the sale of a residence by the homeowner to an investor at its fair market value. The homeowner typically would receive a cash down payment and an installment note pursuant to which the purchaser-lessor would make monthly payments of principal and interest. The purchaser-lessor would then lease the residence back to the seller-lessee pursuant to a standard residential lease agreement at a fair market value rent.

Under existing law, the tax consequences of such a transaction are clear. The seller-lessee, if he otherwise meets the requirements of section 121, would be able to exclude from gross income up to $125,000 of any gain resulting from the sale. In addition, if the seller-lessee received an installment obligation as part of the sale proceeds, he generally would be eligible to report any taxable gain on the installment method pursuant to the provisions of section 453. The seller-lessee also would be required to report as ordinary income the interest paid by the purchaser-lessor on the installment obligation.

The purchaser-lessor in this transaction would be considered the owner of the residence under existing law. He thus could deduct depreciation pursuant to the applicable provisions of section 167 or section 168 and all related expenses pursuant to section 162 or section 212, so long as the investment were considered to be an activity engaged in for profit. While such a determination is inherently factual in nature, the Tax Court has held that the purchase and leaseback of a principal place of residence can be an activity entered into for profit. See Langford v. Commissioner, 42 T.C.M. 1160 (1981). Moreover, the purchaser-lessor would be able to deduct interest paid to the seller-lessee on the installment obligation. Finally, the purchaser-lessor would include in gross income the rental paid by the seller-lessee.

While the tax consequences of the traditional sale-leaseback transaction described above are clear under existing law, such a transaction is not advisable for many homeowners because of the absence of suitable protection for the seller-lessee. For example, because the required rental payments would be set at fair market value, the purchaser-lessor may increase the rent at a faster rate than the seller-lessee's income increases. As a result, the seller-lessee may be forced to relinquish his occupancy rights in the house he formerly owned. Because of the existence of such risks, we understand that few residential sale-leaseback transactions have been consummated.

In an attempt to provide some protection for elderly homeowners who might contemplate a sale-leaseback transaction, an alternative plan has been proposed by several promoters. Under this alternative plan, the seller-lessee would sell his home to an investor at a discount from its fair market value. The purchaser-lessor, in addition to paying a cash down payment and executing an installment note, would purchase a deferred annuity for the seller-lessee. The annuity would be intended to provide an income stream from which the seller-lessee can pay rent after the installment note has been fully satisfied.

The seller-lessee, under a lease agreement with the purchaser-lessor, would rent the home for a rental below the appraised fair market rental value. The required rental payment would be up to 20 percent below the fair market rent in the year of sale, and subsequent rental increases would be limited or prohibited. The discount on the purchase price paid by the purchaser-lessor for the home is designed to compensate the purchaser-lessor for (i) the delay between purchase and ultimate possession of the residence and (ii) the below market rent paid by the seller-lessor. The purchaser-lessor would be contractually liable for the risks and burdens of ownership after the purchase and would be entitled to all benefits of ownership other than the seller-lessee's retained occupancy rights.

While the transaction described above, depending on the precise facts, might constitute a sale-leaseback that would be recognized for tax purposes under existing law, the overall transaction should be treated for tax purposes according to its true economic substance. Unlike the sale of a remainder interest, where the life tenant retains the risks and burdens of ownership, the seller-lessee in a sale-leaseback has shifted most of the benefits and all the burdens of ownership to the purchaser-lessor. In substance, the seller-lessee in such a transaction has received value, in addition to the stated sales price, equal in amount to the purchase price discount and has paid that amount back to the purchaser-lessor as prepaid rent. See Alstores Realty Corporation v. Commissioner, 46 T.C. 363 (1966). Under this characterization of the transaction, the seller-lessee would be required to include the purchase price discount in the amount realized for purposes of computing gain upon the sale of the residence and the purchaser-lessor would have to include the discount in taxable income as prepaid rent.

Description of S. 831

S. 831 would amend section 121 to provide that the term "sale or exchange" includes a transaction in which the seller retains a life tenancy in the property. Thus, a taxpayer who has reached age 55 could sell a remainder interest in his home, in a sale-life tenancy arrangement, and qualify for the section 121 exclusion. S. 831 also would amend section 167 to provide that in the case of property held by one person with a remainder interest acquired by another person pursuant to a sale or exchange qualifying for special treatment under section 121, the depreciation deduction would be computed as if the remainderman were the absolute owner of the property.

Description of S. 1914

The changes sought to be made by S. 1914 are much more extensive than those proposed by S. 831. S. 1914 is intended to establish a safe harbor for residential sale-leaseback transactions structured in the alternative form described above.

S. 1914 would first amend section 167 of the Code to provide the definition of a "qualified sale-leaseback transaction." A qualified sale-leaseback transaction would be one in which the seller-lessee (i) attained the age of 55 before the date of the transaction, (ii) sold property which was owned and used solely as his principal place of residence, and (iii) retained certain "occupancy rights" in the property pursuant to a written lease requiring a "fair rental." The "occupancy rights" that would have to be retained by the seller-lessee in a qualified sale-leaseback transaction are defined by S. 1914 as the right to occupy the residence for a term which (i) equals or exceeds one-half of the life expectancy of the seller-lessee on the date of the sale, (ii) is subject to a continuing right of renewal by the seller-lessee, and (iii) terminates no later than the date of death of the seller-lessee or his surviving spouse. The term "fair rental" is defined to mean a rental that is determined at the date of the sale to equal or exceed 80 percent of the appraised fair market rent. The purchaser-lessor in such a qualified sale-leaseback transaction also would be required by S. 1914 to be contractually responsible for the risks and burdens of ownership after the date of the sale.

If all the requirements of a qualified sale-leaseback were met, the purchaser-lessor would be treated under S. 1914 as the absolute owner of the property and would be entitled to claim depreciation with respect to the property. Second, S. 1914 would add section 121A to the Code to exclude from the purchaser-lessor's income any value attributable to the fair market price discount. Therefore, while the purchaser-lessor would in fact receive the equivalent of prepaid rent through the reduction in the purchase price, he would not be subject to tax on that amount. Third, S. 1914 would amend section 183 to establish a rebuttable presumption that any qualified sale-leaseback transaction is an activity engaged in for profit. Thus, the purchaser-seller generally would be able to deduct all expenses incurred in connection with his ownership and rental of the residence.

The seller-lessee in such a transaction also would be entitled to special tax treatment under S. 1914. First, as under S. 831, the seller-lessee would be entitled to elect the one-time exclusion of gain provided in section 121. Moreover, new section 121A would provide that gross income would not include any value or purchase price discount attributable to retained occupancy rights received in a qualified sale-leaseback transaction. Similarly, S. 1914 would amend section 1001(b) to provide that the seller-lessee's amount realized on the sale would not include any purchase price discount attributable to the retained occupancy rights. Under amended section 1001(b) and new section 121A, therefore, although the seller-lessee receives valuable occupancy rights from the purchaser-lessor, the seller-lessee would not be required to include any such value in income.

In addition to the provisions referred to above, S. 1914 would amend sections 453 and 1001 to provide that if an annuity were purchased for the seller-lessee by the purchaser-lessor, the cost of the annuity would constitute the amount of consideration received by the seller-lessee attributable to the annuity and that cost would be deemed to have been received in the year of disposition. Moreover, section 72(c)(1)(A) would be amended to state clearly that the cost of the annuity would represent the seller-lessee's "investment in the contract." Finally, section 280A would be amended to avoid the restrictions of that section of the Code where there is a qualified sale-leaseback between related parties.

Discussion

The Treasury Department supports the amendment that S. 831 seeks to make to section 121. By enacting section 121, Congress sought to allow an individual who had attained age 55 to remove his investment from his old residence while avoiding tax on the portion of any capital gain up to $125,000, without reinvesting the proceeds from the sale in another residence. We see no reason not to make the section 121 exclusion available where a qualifying homeowner withdraws part of his equity by selling a remainder interest in the residence.

We oppose, however, the amendment to section 167(h) proposed by S. 831. The underlying theory of the depreciation deduction is to permit the proper matching of income and expenses. The holder of a remainder interest cannot realize any income from the property until the remainder interest becomes possessory some time in the future. Such a person should be able to claim depreciation with respect to his basis in the remainder interest only when the property is available to produce income for him.

Moreover, to qualify for a depreciation deduction, the owner of property must prove that he has a depreciable interest in the property, in the sense that he has made an investment in the property and will suffer the economic loss resulting from deterioration through obsolescence or use. While the property may deteriorate in value as it is used by the life tenant, the remainderman presumably suffers no economic loss as a result of that deterioration. The price paid for the remainder interest would take into account the fact that the property would ultimately be received by the remainderman in the deteriorated condition. Thus, a remainderman does not suffer economic loss from obsolescence or use and should not qualify for the depreciation deduction.

Moreover, as discussed below with respect to S. 1914, the allowance of depreciation for a remainder interest in a residence would permit depreciation of the property even though it is producing no gross income for tax purposes (because the imputed rental income of the life tenant would not be treated as gross income). Section 167(h) properly prevents this result.

With the exception of the amendment to section 121, the Treasury Department also opposes S. 1914. The tax benefits arising from a qualified sale-leaseback transaction as defined by S. 1914, other than the change sought in section 121, would accrue primarily to the purchaser-lessor. First, real property, which is owned and used for personal purposes and is thus not subject to depreciation, is shifted to an owner who is able to claim depreciation. The tax consequences arising from such a transfer of property to the depreciable sector are similar to the consequences arising from the sale and leaseback of property by a tax-exempt entity, such as a municipality, to taxable investors. Second, the bill permits tax bracket arbitrage by shifting deductible property tax expense from the low-bracket seller to the high-bracket purchaser. Similarly, tax bracket arbitrage is achieved because interest expense is paid and deducted by the high-bracket purchaser and included in income by the low-bracket seller. Finally, and perhaps most significantly, the value attributable to the purchase price discount, which in substance represents additional purchase price paid to the seller and prepaid rent paid to the purchaser, is not taxed to either party.

We believe that the tax treatment provided by existing law is correct and comports with the true economic substance of the transaction. Therefore, it should not be changed. Moreover, it should be recognized that the tax exemption for the value attributable to the purchase price discount, while in form accruing to the benefit of both the seller-lessee and the purchaser-lessor, would, for two reasons, be of almost exclusive benefit to the purchaser-lessor. First, the value attributable to the retained occupancy rights, if treated as additional sales proceeds to the seller-lessee, would often be excluded from the seller-lessee's income pursuant to section 121. Thus, the tax benefit provided by the amendment that S. 1914 seeks to make in section 1001(b) would be of no value to many elderly homeowners. Second, because the value inherent in the purchase price discount is, in substance, prepaid rent to the purchaser-lessor, S. 1914 has the effect of exempting ordinary income from tax. Therefore, unlike the seller-lessee who derives little tax advantage from the exclusion provisions of S. 1914, the purchaser-lessor realizes a significant tax benefit from those provisions. While it is possible that the purchaser-lessor would share his tax benefits with the seller-lessee by paying a higher purchase price, we question whether this would in fact occur in many cases.

For the reasons discussed, the Treasury Department opposes S. 831 and S. 1914, with the exception of the proposed amendment to section 121.

S. 842
Small Business Participating Debentures

S. 842 would provide special tax incentives for investments in small business participating debentures. Treasury opposes S. 842.

Background

Present corporate tax rules provide substantially different tax treatment for investments in stock and debt of corporations. Generally, distributions of money or other property by a corporation with respect to its stock are not deductible by the corporation and are taxed as ordinary dividend income to the holder of the stock. Distributions by a corporation to a shareholder in redemption of his stock may qualify for capital gains treatment, but the corporation is not entitled to deduct any part of the redemption price. In contrast, interest paid or accrued with respect to indebtedness generally is deductible by the payor and is ordinary income to the recipient.

Other tax consequences turn on the distinction between debt and equity investments. Losses on the sale, exchange, or worthlessness of corporate stock generally are capital losses. One exception provides ordinary loss treatment for losses incurred by individuals on "section 1244 stock" issued by certain "small business corporations," subject to a $50,000 per taxpayer annual limitation ($100,000 on a joint return). In contrast, losses incurred by debt holders (other than certain financial institutions) from the sale or exchange of debts generally are capital losses. Losses from worthlessness of debts (that are not evidenced by securities with coupons attached or in registered form) are ordinary losses, except that "nonbusiness" bad debts owed to taxpayers other than corporations are short-term capital losses. Nonbusiness bad debts generally include losses on loans made primarily with investment motives that are not made in connection with a trade or business of the taxpayer.

These corporate tax rules have the effect of imposing a double tax -- tax at both the corporate level and the shareholder level -- on corporate income that represents a return on equity investments of shareholders. On the other hand, earnings paid out in the form of interest to holders of debt are taxed only once -- to the holder of the debt -- as ordinary income. This disparity between the treatment of debt and equity has been a significant feature of our system of corporate taxation for many years.

Congress has provided limited relief from this double taxation of corporate earnings for corporations which qualify for "S corporation" status. The shareholders of an electing S corporation are taxed directly on their share of corporate earnings, and the S corporation generally pays no corporate tax. There are certain statutory requirements that must be satisfied to be eligible for S corporation treatment. Among other things, an S corporation must have no shareholders that are not individuals (or certain estates and trusts) and must have only one class of stock.

Description of S. 842

S. 842 would provide special rules for payments made with respect to "small business participating debentures" ("SBPDs"). An SBPD is a written "debt" instrument issued by any domestic trade or business (whether or not incorporated) having less than $10,000,000 of equity capital, no outstanding securities subject to certain securities law requirements, and no more than $1,000,000 of outstanding SBPDs. The "debt" instrument must satisfy 5 additional tests: (i) it must be a general obligation of the issuer; (ii) it must bear interest at a rate not less than the "test rate" prescribed for purposes of Code section 483 (presently 9 percent per annum); (iii) it must have a fixed maturity; (iv) it must have no voting or conversion rights; and (v) it must provide for payment to the holder of a share of the total earnings of the issuer. The amount of the issuer's equity capital and outstanding SBPDs is to be determined by treating certain related corporations or businesses as a single entity. No standards are provided in the bill to determine whether a purported SBPD (which is a hybrid instrument) will be classified for tax purposes as a "debt" instrument or an "equity" investment. If an instrument is equity, it apparently would not qualify as an SBPD.

A holder of an SBPD is required to report the stated interest component paid on the obligation as ordinary income, and is entitled to treat his share of the earnings of the issuer as long-term capital gain. The issuer of an SBPD is entitled to deduct as "interest" all amounts (other than principal) paid to holders of SBPDs, including the amounts of earnings distributed to the holders that qualify for capital gain treatment. Holders of SBPDs are not eligible for capital gain treatment if they own actually or constructively (under certain attribution rules) more than 10 percent of the value or the voting power of the stock (or equity) of the issuer (or a related business), or if the SBPDs are held by taxpayers who have reciprocal SBPD investments in each other.

Holders and issuers of SBPDs must treat the payment of a share of the issuer's earnings as having been made on the last day of a taxable year if the payment is made not later than the due date for filing the tax return for such year (plus extensions). Losses suffered by holders of SBPDs would be eligible for ordinary loss treatment to the same extent as losses on "section 1244" stock issued by small business corporations.

The new provisions would be effective for SBPDs acquired after the date of enactment and for taxable years beginning after 1982, but would not apply to SBPDs issued before 1984 unless the proceeds are used to retire certain existing debt incurred to finance inventory or accounts receivable.

Discussion

The Treasury Department opposes S. 842. The revenue loss associated with the bill -- $ 3.0 billion through 1988 -- is unacceptable in these times of fiscal constraint. We further believe that the generally available business incentives that were enacted in the Economic Recovery Tax Act of 1981 -- including the Accelerated Cost Recovery System, expensing of certain property, increased investment credit limits for used property, tax credits for research and experimentation, the 15 year net operating loss carryforward, and the increased accumulated earnings tax credit -- are the best means to stimulate business investment. These generally available incentives are preferable to incentives available only to those who can arrange their affairs to qualify for them. Finally, with the simplification and liberalization of the rules applicable to "S corporations" in the Subchapter S Revision Act of 1982, Congress has further alleviated the burden of double taxation of corporate earnings of small businesses. For these reasons, Treasury believes that the benefits that would be provided by S. 842 are not needed.

We also have serious objections to S. 842 on tax policy grounds. The bill would authorize a security that combines the best features of debt securities and equity investments without the concomitant detriments of either. In fact, in some cases, SBPDs would enjoy better tax treatment than that available to either debt or equity investments. For example, issuers of SBPDs would be allowed to deduct as "interest" the amount paid to holders as a distribution of profits, notwithstanding the fact that present law does not permit corporations to deduct dividends or amounts paid to redeem stock. The holders of SBPDs would receive capital gain treatment with respect to these distributions, similar to the tax treatment when a stockholder's shares are redeemed with funds derived from after-tax corporate earnings in a redemption qualifying for capital gain treatment. Consistency should require the holder to have ordinary income when he receives a deductible distribution from the corporation. There is no apparent justification for treating both sides of the SBPD transaction in an inconsistent fashion, other than to reduce tax rates on certain businesses. However, this objective is achieved at the cost of a substantial loss of coherence in the corporate tax rules.

In the case of distributions of profits to SBPD holders, since the issuer is entitled to an interest deduction, the income so distributed would not be subject to any tax at the corporate level, but only to a single tax at the shareholder level. While this feature of SBPDs may be defended on the ground that it "integrates" the corporate and individual income taxes by eliminating the double taxation of corporate earnings, S. 842 goes much further in that it would tax corporate earnings (which may be derived wholly from "ordinary income" sources) at long-term capital gain rates. The effect of S. 842 thus is to reduce the maximum tax on that portion of a corporation's ordinary income paid to SBPD holders to 20 percent, compared to the present 46 percent maximum corporate rate or the 50 percent maximum individual rate applicable to ordinary income. This is to be contrasted with the treatment of Subchapter S corporations and their shareholders, who are subject to a single tax at the shareholder level at ordinary income rates with respect to the corporation's ordinary income.

Another example of the anomalous treatment of SBPDs is the special rule that provides "section 1244" ordinary loss treatment on the sale or worthlessness of SBPDs. Under present law, section 1244 ordinary loss treatment is available only for certain common stock investments of individuals in small business corporations. The purpose of section 1244 is to encourage equity investments in small businesses by reducing the risk of loss to the stockholders. This special treatment is appropriate only for equity investments because of the relatively high degree of risk involved with such investments. However, SBPDs are debt investments, and they enjoy a priority over all equity investors in the event of a default or bankruptcy. SBPDs might also be personally guaranteed by the stockholders of the issuer (or the owners of an unincorporated business issuing a SBPD could be personally liable for repayment), further reducing the risk to SBPD holders. The bill provides these debt holders with ordinary loss treatment even though there might be common or preferred stockholders standing behind the SBPD holders who would not be entitled to section 1244 ordinary loss treatment with respect to their stock investments because the limitations of section 1244 are exceeded or the requirements of section 1244 otherwise were not satisfied.

Treasury believes there is no reason to prefer debt holders over stockholders (who bear the greater risk) with respect to the tax consequences of loss of an investment. It should be noted that the section 1244 loss treatment provided by S. 842 would be available to debt investors in corporations having 10 times the equity capital base of those presently eligible for section 1244 loss treatment for capital stock. In light of the modest limitations on the size of a corporation eligible to issue stock qualifying for section 1244 benefits, we doubt that such generous treatment of SBPDs is justified.

One final concern is worth noting. SBPDs may be issued by unincorporated businesses such as sole proprietors, but there is no requirement that the loan proceeds be used in the business of the proprietor. Thus, it would be possible for an owner of an unincorporated business to borrow for personal consumption purposes against his business assets while still enjoying the benefits of SBPD treatment. This is not a justifiable result. Nevertheless, nonbusiness use of the borrowed funds would be difficult to prevent.

For these reasons, we oppose S. 842.

S. 1231
Exemption of Piggyback Trailers and Semitrailers from Excise Tax on Heavy Trucks and Trailers

S. 1231 would exempt certain "piggyback" trailers and semitrailers from the excise tax on heavy trucks and trailers. The Treasury Department is opposed to the enactment of this bill. The Department of Transportation has advised us that it also opposes the bill.

Background

Present law, as amended by the Highway Revenue Act of 1982, imposes a tax on the first retail sale of a truck trailer and semitrailer chassis or body equal to 12 percent of the sales price of the vehicle. The tax does not apply, however, if the chassis or body is suitable for use with a trailer or semitrailer having a gross vehicle weight of 26,000 pounds or less. In addition, there are a number of statutory exemptions from the tax, including an exemption for rail vans. A "rail van" is a vehicle that is designed for use both as a highway vehicle and as a railroad car.

Description of S. 1231

S. 1231 would expand the list of statutory exemptions from the 12-percent sales tax to include any chassis or body of a piggyback trailer or semitrailer. A piggyback trailer or semitrailer would include any trailer or semitrailer that is designed for use principally in connection with trailer-on-flatcar service by rail. The bill also generally would require that the purchaser of the chassis or body certify to the seller that the trailer or semitrailer will be used in connection with trailer-on-flatcar service. Finally, the bill would apply as if the provision were included as part of the Highway Revenue Act of 1982.

Discussion

The Highway Revenue Act of 1982 ("HRA") was part of a comprehensive series of changes to the regulation and maintenance of our highway system made by the Surface Transportation Assistance Act of 1982. The changes included tax increases and a restructuring of many of the excise taxes that are used to fund the Highway Trust Fund, including: (i) an increase in the tax on motor fuels; (ii) changes to the heavy vehicle use tax and the tax on tires; (iii) an elimination of the tax on most truck parts and accessories; (iv) an increase in the tax rate on sales of heavy trucks and trailers, combined with an extension of the exemption for light weight vehicles to trucks weighing 33,000 pounds or less and trailers weighing 26,000 pounds or less; and (v) a shift of the tax on heavy trucks and trailers from the manufacturing to the retail level. These changes were made to provide adequate revenues to maintain and enhance the quality of the highway system and to increase the share paid by the heavier vehicles to an amount that more closely reflects their fair share of the cost of expanding and maintaining Federal-aid highways.

The proponents of S. 1231 argue that piggybacks should be exempted from the tax because they generally travel less than 3,000 miles per year on the highways and thus do not contribute much to highway damage. We have insufficient evidence to prove or disprove this allegation, but there is ample evidence that many piggyback trailers travel many more miles.

The problem with an exemption for piggyback trailers is that it is likely, in practice, to result in exempting from tax many vehicles that extensively use the public highways. It is our understanding that the cost of converting an over-the-road trailer (OTR) to a piggyback trailer is substantially less than the 12-percent tax that would be saved if the bill were enacted. In addition, the increased weight of the special equipment necessary to convert an OTR to a piggyback trailer is small enough that it would be economical to purchase a piggyback trailer for use as an OTR. Indeed, if S. 1231 were enacted, we think there would be ample incentive to do so.

Our estimates show that if the existing number of piggyback trailers as a percentage of the total number of trailers remained constant, the bill would have a revenue cost of approximately $15 million per year. However, if the bill were enacted, we expect the number of piggybacks as a percentage of the total number of trailers would increase substantially simply because trailer owners would purchase piggybacks in order to avoid the 12-percent tax. A procedure under which the buyer certifies to the seller that the buyer intends to use the vehicle for a particular purpose would not remedy this problem since such a system would be subject to wide-scale abuse and would be impossible to police. Taxes collected yearly from trailer sales total approximately $200 million. A significant portion of this revenue might be lost if S. 1231 were enacted.

Finally, the fact that the HRA included an exemption from the 12-percent sales tax for rail vans that are used both as highway vehicles and as railroad cars does not imply that a similar exemption should be granted to piggyback trailers. The exemption for rail vans was based on the assumption that a rail van would be used for only limited highway travel. The overall structure of a rail van is such that it would be very expensive and uneconomical to use it as an OTR. The cost of the special equipment necessary to equip a trailer for use as a rail van would increase the total cost of the trailer by 2-1/2 to 4 times; thus, there is no incentive to avoid the 12-percent tax by ordering the additional equipment. Moreover, the special equipment for rail vans would increase the weight of a trailer by up to 6,000 pounds, making it uneconomical for use as an OTR. As explained above, however, the same is not true for a piggyback trailer.

For these reasons, the Treasury Department and the Department of Transportation oppose exempting piggyback trailers and semitrailers from the excise tax on heavy trucks and trailers.

S. 1807

Exclusion from Subpart F Income for Certain Dividends Paid from Agricultural Commodities Income

S. 1807 would provide that certain dividends received by controlled foreign corporations will be excluded from the recipient's subpart F income where the dividends are paid out of income derived from certain agricultural commodities. The Treasury Department opposes S. 1807.

Background

A foreign corporation more than 50 percent of the total combined voting power of which is owned, directly or indirectly, by certain U.S. shareholders is a controlled foreign corporation (CFC). U.S. shareholders are required to include in their gross income the subpart F income of the CFC, even if such amounts are not actually distributed to those shareholders. Dividends received by a CFC are treated as subpart F income, with certain very limited exceptions.

Description of S. 1807

S. 1807 would broaden the category of dividends eligible for exception from subpart F income treatment. Under the bill, dividends received by a CFC from a related company would not be subpart F income if (1) the recipient and payor of the dividends are foreign corporations controlled by the same U.S. shareholder, (2) the recipient and the payor were in existence for at least the 5-year period prior to the date of acquisition by the U.S. shareholder, (3) the payor was engaged in the active conduct of a trade or business during such 5-year period, and (4) at least 70 percent of the gross income of the company paying the dividends was derived from the purchase or sale of agricultural commodities which are not grown in the United States in commercially marketable quantities.

The bill would apply to taxable years of foreign corporations beginning on or after January 1, 1984.

Discussion

The CFC provisions of the Code were enacted generally to eliminate tax deferral with respect to certain income of U.S.-controlled foreign corporations where such income was derived from transactions with related persons and did not otherwise originate in the foreign country of incorporation. Thus, dividends received by a CFC are, with certain narrow exceptions, treated as subpart F income. The exception to subpart F income treatment contemplated by S. 1807 is contrary to the purpose of the CFC provisions of the Code.

The premise for the agricultural commodities income requirement in the bill stems from another exception to subpart F income treatment. Normally, income of a CFC from the purchase and sale of goods is subpart F income if the goods are purchased from, or sold to, a related person. An exception from such treatment exists in the case of trading in agricultural commodities not grown in commerically marketable quantities in the United States. The argument proceeds that since the trading income is not subpart F income, the dividends paid from that income should not be subpart F income. However, in many cases a foreign subsidiary may engage in business activities not resulting in subpart F income if paid to a CFC. Nevertheless, dividends normally are subpart F income.

One of the basic policies of the CFC provisions is that U.S.-controlled foreign corporations should not be able to transfer funds not previously subject to U.S. tax so as to benefit the U.S. parent without the imposition of a U.S. tax at the time of the transfer. Pursuant to this clear policy, dividends received by a U.S.-controlled foreign subsidiary are treated as subpart F income to the recipient corporation. We see no reason to deviate from this policy in this case.

S. 1807 is intended to benefit Consolidated Foods Corporation. Consolidated Foods sought, but did not receive, a ruling from the Internal Revenue Service that dividend income received by a foreign subsidiary would not be subpart F income under section 954(b)(4). Section 954(b)(4) provides that income received by a CFC will not be subpart F income if it is established that neither the creation or acquisition of the CFC nor the effecting of the transaction giving rise to such income through the CFC had as one of its significant purposes a substantial reduction of taxes. Due to its very nature, application of this test requires a factual determination by the Internal Revenue Service, as do a number of other Code provisions applicable to foreign transactions (such as section 367). It would be an extremely undesirable precedent for Congress to override the factual determination made by the IRS in this case solely to benefit one corporation.

For these reasons, Treasury opposes S. 1807.

* * *

This concludes my prepared remarks on these bills. I would be happy to respond to your questions.

Revenue Effect of Selected Tax Proposals

($ billions)

	Fiscal Years				
	1984	1985	1986	1987	1988
Facilitation of home equity conversion through sale-leaseback transactions (S. 1914)	*	*	*	*	*
Small Business Participating Debentures (S. 842)	*	-0.2	-0.5	-1.1	-1.8
Small Business Administration guarantee of tax-exempt IDBs (S. 449)	*	*	*	*	*
Excise tax on piggyback trailers (S. 1231)	*	*	*	*	*

Office of the Secretary of the Treasury
Office of Tax Analysis

October 27, 1983

*Less than $50 million.

Statement of Senator Charles H. Percy
Committee on Finance
Subcommittee on Taxation & Debt Management
October 28, 1983

Mr. Chairman and members of the subcommittee, thank you for scheduling this hearing today on S. 1807, a bill I introduced with Senator Dixon on August 4, 1983. We introduced this bill because a situation was called to our attention in which the Internal Revenue Service is not correctly or adequately adminstering the tax law.

The tax law clearly provides that the income of a foreign subsidiary of a U.S. corporation which was not formed for tax avoidance purposes will not be subject to current U.S. taxation. In other words, the income will be "deferred" if the transaction giving rise to the income did not have as one of its principal purposes a substantial reduction of income taxes.

The situation called to my attention involves a Dutch subsidiary of a U.S. corporation, Consolidated Foods Corp. The Dutch company was founded in 1753 and is one of Europe's most prominent food retailers. Several years before there was any involvement or ownership by Americans in this Dutch company, it created a Swiss subsidiary to do its coffee trading business. The Swiss subsidiary paid dividends from its coffee income to its Dutch parent company for use in the parent's other business operation.

The Internal Revenue Service now appears to have taken the position that the Dutch company formed centuries ago, the Swiss company formed years before any U.S. interest was involved and the payments of dividends identical to those paid during the pre-U.S. involement years--and from an identical type of income--were all done for tax avoidance purposes.

I am sorry IRS has developed this unhelpful outlook. It is not sensible and it is not based on the present law. I would have preferred that IRS would consider the facts as they stand and rule favorably on behalf of Consolidated Foods. However, they continue to maintain their present position despite appeals from the company involved, meetings with Treasury Department officials and appeals from Congress.

In light of IRS' position, our bill clarifies the law and gives IRS reasonable guidelines to operate under. The bill provides that if the foreign subsidiaries had been formed and in operation for some time before any U.S. involvement and the income giving rise to the dividend was otherwise eligible for deferral from current U.S. taxation--that is, it arose from sales of agricultural commodities not grown in commercially marketable quantities in the U.S.--then the dividend will be eligible for deferral when paid to the foreign parent.

Since my bill clarifies the operation of present law, there will be no revenue loss upon its enactment.

Thank you for your time and consideration, Mr. Chairman. I urge the subcommittee and committee to act favorably on S. 1807.

Senator **Packwood**. I see both Senator Levin and Senator Specter here. We'll take them both right now.

Gentlemen, I know you have other commitments, so I appreciate you waiting until Treasury finished.

Senator **Specter**. Thank you very much, Mr. Chairman. Senator Levin has just deferred to me under the doctrine of first in time, first to arrive, and I shall respond to his generosity with brevity.

STATEMENT OF HON. ARLEN SPECTER, U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator **Specter**. I first thank the chairman for scheduling this hearing in conjunction with an earlier event of today, squash at 7 a.m., which had to be postponed. I commend the chairman for his hardworking endeavors, one of the few who is available at 7 a.m.—strike that—the only one who is available at 7 a.m.

Mr. Chairman, I testify today in favor of S. 1914. Simply stated—and I ask that my full testimony be made a part of the record—I shall summarize it.

Senator **Packwood**. You might want to address yourself to what Treasury said. Did you hear their testimony?

Senator **Specter**. Yes. I think Treasury was entirely right when they agreed with the portion of the legislation which would exempt the sale leaseback transaction for a one-time capital gains exemption, which is otherwise available to homeowners past the age of 55 who sell their homes.

I heard their objection to permitting the purchasor lessor to take depreciation on the value of the property, and it seems to me that that kind of depreciation would be appropriate under normal depreciation rules. This legislation seeks to make it plain so that purchasor lessors will not be speculating about a possible adverse IRS position or an adverse judicial decision. If someone buys this kind of an interest, it seems to me that they are entitled to depreciation in due course. To the extent that there is a tilt, to use the chairman's expression in another context, I think it is a very justifiable tilt, because we will be having a very desirable social consequence, and that is to promote cash in the hands of the elderly who need the cash at a time when their financing is very much in the public sector, with the wide variety of Federal programs.

Senator **Packwood**. I also find it very justifiable. I am frankly not very impressed with Treasury's argument. They will use the argument that this will be a tax shelter for rich doctors and lawyers. If we are going to tilt in this direction to try to keep the elderly in their homes, which is where they would prefer to stay and where we would prefer to have them, someone has to buy their equity. All of a sudden that becomes converted into a "shelter," and then a "loophole," and then it's evil because it has helped achieve an end that we are trying to achieve. In my mind, I see nothing wrong with that.

Senator **Specter**. Well, Mr. Chairman, I think it has enormous potential to help a group which needs help and to help a group which otherwise is going to be needing more Federal assistance.

There is a vast sum of equity estimated at $50 billion, and I think probably much more, in the homes of people who are over 55.

And they have a remainder interest which has enormous value. They have to live in the homes, and under existing law they cannot work it out so that they use up the value until the time of their death. But if this bill were enacted so that their remainder interest could be sold and computed on an actuarial basis, someone who bought a house 30 years ago for say $27,000, like I did in 1960, today the house is worth perhaps $140,000 just from normal appreciation and inflation. Happily, I am not yet 55 and so not quite eligible for the provision; but that would enable someone slightly older to sell the remainder value which would be probably $50,000-$60,000. There is no reason why that person shouldn't be able to utilize the value during his lifetime instead of leaving it to someone—perhaps a distant cousin, perhaps escheat to the State, or who knows. At least he has that option. And he should be entitled to the capital gain provision, the one-time exemption past 55. To provide a stimulus to have people want to buy this as purchaser lessors makes preeminently good public policy sense to me. And I would hope that we could move it ahead.

Senator PACKWOOD. Thank you.

Senator SPECTER. Thank you very much, Mr. Chairman.

[Senator Specter's prepared statement follows:]

TESTIMONY OF SENATOR ARLEN SPECTER
BEFORE THE SENATE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT ON S. 1914,
"THE HOME EQUITY CONVERSIONS ACT OF
1983"

I thank the distinguished Chairman, Mr. Packwood, for allowing me to appear before the Subcommittee on Taxation and Debt Management to testify regarding my bill, S. 1914, "The Home Equity Conversions Act of 1983," which replaces S. 831, which I introduced earlier in this Congress. While the original bill only addressed depreciation and capital gains exclusions, this measure seeks to further clarify the tax code in an attempt to define legislatively the limits of sale-leaseback transactions in home equity conversions. The further tax code clarification sought by this measure is intended to more firmly safeguard the rights of the elderly seller, to which I remain steadfastly committed.

This legislation is an important first step in enabling elderly homeowners to maintain residency while they, at the same time, convert the equity in their homes into income. It has attracted considerable interest and has had the benefit of review and comment by numerous home equity conversion experts who testified on sale-leaseback transactions -- for older homeowners in a fact-finding session held by the Federal Council on Aging on September 14, 1983. I am hopeful that this hearing will bring greater attention and understanding to a solution that will alleviate the plight of elderly homeowners on fixed incomes.

Our elderly homeowners living on fixed incomes often face a cruel choice. Confronted by ever-rising living costs, they must either reduce their standard of living, or sell their most precious asset, their home, to pay their bills.

The trauma of losing a home for which a person has worked a lifetime is profound. The alternative, however, is equally dismaying: living out one's last years -- the allegedly golden ones -- in materially constrained circumstances. It is an alternative no elderly homeowner should have to face if an alternative can be devised.

My bill facilitates sale-leaseback arrangements for elderly home equity conversions. Under this arrangement, rather than having to sell for funds to meet living expenses and moving into an apartment, the elderly homeowner can sell to a financial institution or a third-party investor, but continue to live in his or her own home under a lease. The homeowner can pay the lease payments out of the proceeds of the sale which may be in the form of cash, mortgage payments, or annuities.

Tax ramifications to sale-leaseback transactions would be clarified by this legislation which I have proposed. First, the elderly homeowner in the sale-leaseback transaction would be entitled to a one-time capital gains tax exemption that is otherwise available to homeowners past the age of 55 who sell their homes. Second, the purchaser/lessor could take depreciation on the value of the property it had purchased although the seller retains occupancy rights. In addition, several other changes have been made, modifying the original bill, S. 831, in an effort to further clarify the tax code and safeguard the rights of the seller, including but not necessarily limited to, the replacement of the controversial "sale-life tenancy" with "sale-leaseback" as the specific conversion mechanism to be used; the inclusion of language defining what constitutes a "qualified sale-leaseback transaction"; the exclusion of the value of occupancy rights in any computation of gross income or gain or loss to the seller; the extension of the installment method of accounting as a proper method of reporting income in sale-leaseback transactions involving home equity conversions; and the cost of an annuity as the determination of its value in a sale. In sum, from a tax standpoint, this bill seeks to treat an elderly homeowner who sells his home and moves out to rent elsewhere no differently than an elderly homeowner who sells his home yet elects to remain in his home, paying rent to the purchaser.

With these tax ramifications clarified, I am confident that this legislation, in its present form, will be a sound first step forward toward safeguarding the rights and interests of the elderly while maintaining the attractiveness of the sale-leaseback transaction to financial institutions and third-party investors.

I am firmly committed to taking all necessary measures to protect the elderly seller in a sale-leaseback transaction. Commensurate with this view, I welcome any suggestions raised at this hearing, and subsequent to this hearing, which seek to modify this bill in an effort to provide greater protection to the elderly homeowner. The overall intent of this legislation is to permit senior citizen homeowners to convert the value of their homes into liquid assets to meet current needs while still living in the homes. It addresses the needs of many elderly citizens who own homes with substantial appreciated value but live on low, fixed incomes.

I thank the Chairman for allowing me this opportunity to comment on S. 1914, "The Home Equity Conversions Act of 1983." I am hopeful that this legislation will receive serious consideration by this subcommittee.

Senator PACKWOOD. Senator Levin.

STATEMENT OF HON. CARL LEVIN, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you, Mr. Chairman. I am here on the Pollution-Control Financing Guarantee program, S. 499 to the continued viability of that program. As a member of the Small Business Committee, I have been very much involved in trying to help small business finance the purchase of pollution control equipment.

Congress has taken two actions in the past relevant to this program. First, we have told businesses they must buy pollution control equipment to meet Government mandated pollution control standards. Second, we told SBA that it could guarantee loans to small businesses if it wanted to, even though the source of the financing for those loans was a tax-exempt bond. In the chairman's words, we wanted to give that small tile to small business. In my opinion we did it very consciously.

We told the SBA, "Yes, you are authorized to give those loan guarantees to buy that equipment which we have imposed on people, if you want to."

That's the two actions Congress has taken so far.

And then the OMB came along in late 1981 and said, "Well, Congress told you, SBA, that you could. But we're telling you, SBA, you can't."

So the question that this committee and the Congress faces consists of two parts. One is: Were we right in telling SBA that they could authorize loans to small businesses to buy this mandated equipment; and, No. 2, who is passing the laws in this country—Congress or the OMB?

Senator PACKWOOD. You and I think we were right; there's no question, we did it. In any event, whether we were right or wrong, we told SBA they could do it.

So then the question becomes, Congress having said Yes, where is the authority to say "I don't care what Congress said, I don't care what the law is, the answer is No"?

Senator LEVIN. That is exactly the issue. I would like to insert in the record my statement which does contain in part the opinion of the Congressional Research Service saying, "There appears to be no firm legal basis for OMB's authority to order the termination of the program." The opinion of the CRS is that "it would not be unlikely for a court to find SBA's termination of the program unlawful." I would like that opinion to be made a part of the record.

Senator PACKWOOD. We would be very happy to have it in the record.

Senator LEVIN. Second, I would ask that a letter from the Small Business Administration to the Director of OMB, David Stockman, dated April 29, 1982, be made a part of the record. In that letter, SBA is appealing the decision of the OMB to deny this guarantee authority. I would also ask that a copy of OMB's response be inserted in the record. It is obvious from this exchange of correspondence and from the CRS opinion that the SBA would guarantee these loans but for the OMB decision not to let them do so on the merits.

What has happened to this program is clear: During the fiscal quarter prior to the OMB decision taking away SBA's authority granted by Congress, SBA guaranteed $41 million in loans. That's about $14 million a month that they guaranteed.

After the OMB decision, in the 21 months since January 1982, SBA has guaranteed only $18 million in loans—less than $1 million a month compared to the $13 million a month before the OMB decision.

It is clear what the impact of the OMB decision has been. Everybody is paying for it, because our air is a lot less healthy and a lot less clean when small business cannot get these loan guarantees; that's very clear from the numbers that I have just given to the Chair.

But there are really two issues here. One is on the merits, where we have already acted, and where it is clear what we intended. We want this pollution equipment to be installed. We want to help small business, and we have authorized the SBA to do it.

There is also a more fundamental issue, and I hope that we will make it absolutely clear to the OMB: It is the Congress that passes the laws around here. And if we authorize an agency to do something, we don't expect the OMB to revoke that authority. If they try to do so, we are going to turn the authorization into a requirement and make the language mandatory instead of permissive.

I don't know of any other way that Congress can preserve an institutional position, and I think we have got to do it very strongly.

Senator PACKWOOD. It is unfortunate. We end up with these internicene warfares, going back, at least in my career, with impoundment. Most of them could be avoided with good faith on both sides.

Senator LEVIN. I couldn't agree with you more.

Senator PACKWOOD. You arrive at this knocking-heads struggle, and ultimately we have the right to pass laws. We have the right to pass wrong laws, if we want—unfounded laws. But, that's what our Founders intended.

Thank you very much.

Senator LEVIN. Thank you.

[Senator Levin's prepared statement plus the April 29, 1982, letter from the SBA to the Director of OMB follow:]

STATEMENT OF SENATOR CARL LEVIN
ON S. 499
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
OCTOBER 28, 1983

Mr. Chairman, thank you for holding this hearing. I appreciate the opportunity to testify on S. 499, which was unanimously approved by the Senate Small Business Committee earlier this year. This legislation would ensure that two important programs designed to benefit small business are administered by the Small Business Administration as Congress intended.

The first program addressed by this legislation is the 503 Certified Development Company program. This program, referred to by Administrator James Sanders as SBA's "flagship" program for economic development, has proven its effectiveness in creating new jobs and economic growth, and has demonstrated the importance of the use of tax-exempt bonds.

Under the program, SBA is authorized to guarantee debentures issued by certified development companies, the proceeds of which are used to assist small business concerns finance long-term, fixed-asset projects. By law, the guaranteed debenture may constitute no more than 50 percent of the financing of any given project. The remaining 50 percent of the financing is derived from the small business itself, a bank, or possibly from the proceeds of an Industrial Development Bond.

To date, over 450 SBA-approved certified development companies have been established nationwide. This source of financing has helped business create or retain over 40,000 jobs, and promote economic development in communities of every size throughout the country.

I strongly support that portion of S. 499 that would permit SBA to continue to guarantee debentures in which a portion of the financing is derived from the proceeds of Industrial Development Bonds.

But I would like to focus my testimony today on a lesser known, although critically important SBA program addressed by S. 499 -- the Pollution Control Bond Financing Guarantee program.

The pollution control program was established by Congress in 1976 in order to help small business comply with mandatory pollution control requirements imposed by Federal, state, and local governments. At that time, Congress recognized the significant difficulties small business faced when seeking access to financing for the purchase of non-productive, non-revenue producing pollution control equipment.

Moreover, Congress realized then, and the Small Business Committee has recently reconfirmed, that small business as a group is generally unable to obtain financing for pollution control equipment through the issuance of tax-exempt bonds unless coupled with the SBA guarantee. By contrast, larger firms, by virtue of their size and bond ratings, can attract sufficient investor interest in tax-exempt bond issues for their pollution control needs.

Under the pollution control program, Congress authorized SBA to guarantee 100 percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities. To ensure that small businesses could obtain tax-exempt financing in the same manner as larger business, Congress specifically wrote into law that SBA could guarantee loans made with the proceeds of tax-exempt bonds. Section 404(b)(1) of the Small Business Investment Act of 1958 states:

> "Notwithstanding any other law, rule, or regulation or fiscal policy to the contrary, the guarantee authorized in the case of pollution control facilities or property may be issued when such property is acquired by the use of proceeds from industrial revenue bonds which provide the holders interest which is exempt from Federal income tax."

The Small Business Committee has received considerable testimony over the past few years on the vital role this program plays in helping small business. That testimony revealed that many small businesses seeking financing for pollution control equipment were unable to obtain assistance because of a Congressionally imposed ceiling on the program. In response, legislation was approved increasing the program level to meet this need.

In addition, the testimony clearly indicated that access to tax-exempt financing is an essential requirement if the program, even with its 100 percent guarantee, is to be a meaningful tool to assist small business, and to meet important pollution control objectives.

Despite the clear need of small business and the specific statutory authority, OMB directed that effective January 1982, SBA not issue guarantees in conjunction with tax-exempt financing for pollution control equipment for small business.

OMB's decision virtually shut down one of the most successful SBA programs. Between 1976 through 1981, SBA assisted 213 small firms, with only two defaults, for a total of $256 million in loans. Of that total, $41 million alone was guaranteed in the fiscal quarter prior to the OMB decision. Since January 1982, SBA has cumulatively guaranteed only $18 million in loans.

The impact of this decision is especially troubling given the substantial financing burden facing small business. According to a recent EPA study, at least $240 million, and possibly more, will be necessary in order for small business to comply with the EPA's effluent guidelines and several other EPA regulations recently promulgated or under consideration. I would ask that a short summary of this study be incorporated in the hearing record.

It is also apparent that SBA would carry out the program as Congress intended but for the OMB decision. I ask that an April 29, 1982, letter from SBA Administrator James Sanders to OMB Director David Stockman appealing the OMB decision be included in the record. I would also ask that OMB's May 26, 1982, response denying that appeal be included in the record as well.

Earlier this year, I asked the Congressional Research Service to review the legality of the OMB decision. Their report concluded that:

> "There appears to be no firm legal basis for OMB's authority to order the termination of the program. From this we conclude that it would not be unlikely for a court to find SBA's termination of the program to be unlawful . . . and in violation of the Fifth Amendment for its failure to afford adequate notice of the agency's action to members of the public who were meant to be benefited by the program and who had justifiably relied on its continuation to their material detriment."

I ask that the full text of this report be included in the hearing record.

Mr. Chairman, I believe that OMB's decision is in direct contravention of explicit statutory provisions, and should be reversed. S. 499 would achieve that end, but would not change existing law or Congressional policy. It would not affect the legal reality of the availability of tax-exempt bonds for pollution control purposes. Nor would it alter the existing Congressional policy of guaranteeing loans derived from the proceeds of tax-exempt bonds. Rather, S. 499 simply reasserts the primacy of law over arbitrary OMB action, and ensures that small business are fully able to take advantage of a critical Federal program to meet their financing needs for pollution control. I would urge the Finance Committee to expeditiously approve this legislation, and permit the full Senate to reinforce our previous, correct judgement.

Again, thank you for permitting me the opportunity to testify on S. 499.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MAY 26 1982

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OFFICE OF THE ADMINISTRATOR

Mr. James Sanders
Administrator
Small Business Administration
Washington, D.C. 20416

Dear Jim:

I have reviewed the statements presented in your April 29, 1982, letter appealing the decision to deny guarantee authority for tax-exempt pollution control equipment financings. Our decision to deny the appeal is consistent with the Administration's efforts to preclude tax-exempt revenue financing especially in conjunction with an indirect Federal guarantee, as in this SBA program.

It is the Administration's view that taxable sources of funds are available to credit worthy borrowers as evidenced by the SBA having received applications for taxable financing since the new policy was announced. Further, we understand that a few states polled have said they do not see a prohibition to their issuing taxable IRB's. When one compares even the increased amount of guarantee authority available for use by SBA to the amounts invested by small businesses over the years to comply with Federal and state pollution control regulations, the logical conclusion is that most firms incorporate the cost of controlling pollution in the cost of producing goods and are able to obtain financing without the intervention of the Federal Government.

As you point out, I am aware that the Congress has initiated actions to mandate that SBA consider applications to guarantee pollution control projects financed by tax-exempt bonds. Your continued support of the Administration's position on this issue makes a significant contribution to assuring the success of the President's economic policy objectives.

Based on an opinion rendered by the SBA General Counsel, you also requested permission to process all pending applications for guarantee of tax-exempt financing. We have reviewed the SBA opinion, the statute, and the regulations and conclude that the letter of the statute is permissive and the regulations do not interfere with the Administration's prerogative to exclude tax-exempt financing from the program. Therefore, permission is denied. Your General Counsel should contact Michael Horowitz (395-4852), if he has any questions.

Sincerely,

Joseph R. Wright, Jr.
Deputy Director

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

APR 29 1982

Honorable David A. Stockman
Director
Office of Management and Budget
Washington, D. C. 20503

Dear Mr. Stockman:

The Small Business Administration has been given a fiscal Year 1982 program level by the Office of Management and Budget of $150 million for its Pollution Control Equipment Contract Revolving Fund (See the enclosed letter of Joyce J. Walker, April 14, 1982 and the Apportionment and Reapportionment Schedule dated December 31, 1981). In addition OMB has required through the apportionment process that SBA utilize its authority for the Pollution Control Financing Guaranty Program to guarantee contracts which are financed by the proceeds of bonds or other financing vehicles the interest of which is taxable to the holders, rather than by the proceeds of bonds which generate tax-exempt interest as has been the case until now.

As a result of the restriction on SBA's authority to guarantee tax-exempt financings under its Pollution Control Financing Guarantee Program, SBA has received both constituent and Congressional comment opposing, among other things, the enactment of this new policy with no prior public notice. The program has come to a virtual standstill, with no guarantee actually issued since December 1981, for two principal reasons:

1) The higher cost of money and increased fees under available taxable financing has precluded small business concerns from participating based on credit considerations.

2) Because taxable financings had not heretofore been utilized under this program, the banks, brokers, and bond issuing authorities involved were not prepared to create and sell the requisite taxable debt instruments to investors.

SBA is greatly concerned about the applications for guarantee - some $129 million worth - that had been received for processing prior to the decision by the OMB. Many of these applicants were under time constraints imposed by regulatory authorities. In some cases, applicants had already incurred engineering and other pre-construction expenses.

In short, SBA is of the opinion that the effect of eliminating tax-exempt financing has been more detrimental to this program than was originally supposed. Additionally, conversion of the program to operate at any meaningful volume on a taxable basis will take more time and effort than previously estimated because of the regulatory approvals and marketing reorientation required with respect to the underlying debentures.

Of equal importance, this Agency is concerned that it has acted in apparent violation of the authorizing legislation and its own regulations concerning this program. Enclosed is an opinion of SBA's Acting General Counsel which concludes that the Agency should publish a notice in the Federal Register of its intent to guarantee only taxable financings from the date of publication forward but to consider all applications received prior to the date of publication on a case-by-case basis consistent with past practice where the underlying financing is nontaxable.

Historically, Public Law 94-305 passed in 1976 authorized the SBA to guarantee 100 percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities or equipment. The program was designed to allow small businesses to obtain access to the tax-exempt municipal bond markets. This would put them on more equal footing with their large competitors, who are already able to receive favorable rates and terms for their pollution control financing.

The process begins when a public entity issues tax-exempt pollution control revenue bonds. The term of repayment of the bond is typically 20-25 years. The business enters into a contract with the issuer of the bonds stipulating that periodic payments in sufficient amounts to cover the interest payments to the bondholders to redeem the bonds as they mature will be made by the small business. The The ability of the small business to comply with the terms of this contract is guaranteed by SBA.

Under the program, bond financing is available on terms up to 30 years at competitive rates. Up to $5.0 million per small business may be obtained through this bond financing method.

The program was designed to be and is self-sustaining. Although Congress appropriated $15 million in 1976 to cover losses, this amount has never been needed and still remains available. In addition, fees and interest earned on fees invested in excess of $25 million have been collected to cover any losses that might be experienced. This provides a total loss reserve of over $40 million. The probability of losses is minimized by the overall stringent credit criteria, the eligibility requirements of the program and the high levels of cooperation between the public and private sectors in implementing the program.

During its nearly 6 years of operation the program has assisted over 225 companies. Through Fiscal Year 1981 the amount of principal that SBA has guaranteed totals $295 million. Since its inception the program has experienced minimal defaults and generated a positive cash flow.

Although the Agency is in agreement with the efforts of the Administration to reduce tax-exempt instruments in the market place, our experience as noted above is that the program has proven invaluable to small firms seeking to meet pollution control requirements and preserve their existence with small overall cost to the taxpayer and the Government.

The Congress is also aware of our favorable experience and SBA is concerned that the Administration's existing options with regard to the operation of this program on a taxable financing basis at a reduced appropriation level may be foreclosed by legislative action. For example, H. R. 6086, which is about to be considered by the House Committee on Small Business would as drafted take away SBA's discretion to not consider applications to guarantee pollution control projects financed by tax-exempt bonds.

Therefore, I am appealing the decision to deny guarantee authority for tax-exempt pollution control financings. At a minimum, permission should be given, consistent with the opinion of our General Counsel, to process all applications for guarantee received prior to the publication of proper notice.

Sincerely,

/S/ James C. Sanders

James C. Sanders
Administrator

Enclosures

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cc: [illegible]
[illegible]
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U S SMALL BUSINESS ADMINISTRATION
WASHINGTON, D C 20416

Date: APR 16 1982

To: Edwin T. Holloway, Associate Administrator
Finance & Investment

From: Robert B. Webber
Acting General Counsel

Subject: Pollution Control Bond Program

You have requested the opinion of this office regarding how future activities relative to the pollution control bond program may be conducted. Your request has arisen because of the insistence of the Office of Management and Budget that this Agency in Fiscal Year 1982, not guaranty contracts which are financed by the proceeds of tax exempt bonds. In this regard, you have specifically requested that we examine the Agency's legal authority to operate the program in order to determine if that authority supports OMB's position.

The authority we are concerned with is found in subsection 404(b) of the Small Business Investment Act of 1958, which provides in part:

> "(b) The Administration may, whenever it determines that small business concerns are or are likely to be at an operational or financial disadvantage with other business concerns with respect to the planning, design, or installation of pollution control facilities, or the obtaining of financing therefor (including financing by means of revenue bonds issued by States, political subdivisions thereof, or other public bodies), guarantee the payment of rentals or other amounts due under qualified contracts. Any such guaranted may be made or effected either directly or in cooperation with any qualified surety company or other qualified company through a participation agreement with such company. The foregoing powers shall be subject, however, to the following restrictions and limitations:

> (1) Notwithstanding any other law, rule, or regulation or fiscal policy to the contrary, the guarantee authorized in the case of pollution control facilities or property may be issued when such property is acquired by the use of proceeds from industrial revenue bonds which provide the holders' interest which is exempt from Federal income tax."

The above-cited provision was added to the Small Business Investment Act by section 102 of Public Law 94-305, approved June 4, 1976. Since that time, the SBA has administered its pollution control program exclusively on the basis of the utilization of tax exempt financing. That is to say, that the underlying contract which is guaranteed by the SBA pursuant to the authority contained in subsection 404(b) is financed with the proceeds of bonds issued by States, political subdivisions thereof, or other public bodies, which provide the holders interest which is exempt from Federal income tax. SBA has, however, interpreted the above-cited language of subsection 404(b) to mean that it may guarantee contracts which are financed by taxable financing as well as tax exempt financing. However, it must be kept in mind that prior to 1982, SBA has never guaranteed a contract which was supported by taxable financing. In addition, SBA's regulations governing the pollution control program clearly indicate that the utilization of tax exempt financing is contemplated as a normal feature of administration of the program. See for example 13 C.F.R. § 111.2.

As part of its budget submission for Fiscal Year 1982, the Carter Administration requested $125 million in guarantee authority to operate the pollution control program. That request was modified by the Reagan Administration in March of 1981 to be $95 million for Fiscal Year 1982. Thereafter, by virtue of Public Law 97-35, effective August 13, 1981, Congress authorized and the President signed into law the following authorization for the pollution control program for Fiscal Years 1982 and 1983:

> "For the programs authorized in sections 404 and 405 of the Small Business Investment Act of 1958, the Administration is authorized to enter into guarantees not to exceed $250 million."

Thereafter, SBA at the behest of the Administration made a revised budget request for the pollution control program for Fiscal Years 1982 and 1983 of $250 million in each year. However, on November 5, 1981, OMB transmitted a credit control memorandum to SBA which directed SBA to expend no more than

$50 million in guarantee authority on the pollution control program in Fiscal Year 1982. Thereafter, discussions ensued between SBA and OMB, the result of which was an Administration position that SBA should utilize $150 million of guarantee authority in both Fiscal Years 1982 and 1983 for the pollution control program. However, this authority was not to be used in conjunction with tax exempt financing after December 31, 1981. This request has been rejected by Congress which has insisted that SBA utilize the entire $250 million authorized for Fiscal Year 1982, and has repeatedly expressed its desire that the authority be used in conjunction with tax-exempt financing.

The issue thus arises as to whether SBA should as a matter of law and policy restrict the utilization of guarantee authority for the pollution control program in 1982 to contracts financed by taxable financings. As stated above, it has been SBA's view that a clean reading of the statutory language indicates that SBA is empowered to issue guarantees of contracts which are financed by either taxable or tax exempt financing. Furthermore, the legislative history of the relevant provision is replete with indications that Congress intended to establish a program which provided SBA with the ability to guarantee contracts financed by tax exempt financing. In this regard, your attention is directed to H.R. Rep. No. 94-1115, 94th Cong., 2d Session 5 (1976), the Conference Report accompanying S. 2498, which eventually became Public Law 94-305, at pages 11 through 12. This report clearly indicates that the SBA guarantee may be issued when the property is acquired through the proceeds from the sale of industrial revenue bonds which provide the holders interest which is exempt from Federal income tax. Your attention is also directed to H.R. Rep. No. 94-519, 94th Cong., 1st Session 9 (1975), to accompany H.R. 9056 at pages 6 through 10, and 13, and Rep. No. 94-420, 94th Cong., 1st Session 10 (1975), to accompany S. 2498, at pages 5 through 6. These reports are also replete with references to the utilization of tax exempt financing as a vehicle for financing the contracts to be guaranteed by SBA under the pollution control program. For example, the above-referenced House report states at page 12:

> "The Administration has voiced opposition to this Title based upon its general oppostion to tax exempt industrial bonds. Your Committee neither endorses nor rejects the concept of such bonds. But the fact is that such bonds are now a legal reality; they have been and are being issued, but only large firms are benefiting from them.

> Your Committee's position is that as long as tax exempt industrial bonds are a reality, small business as well as big business should be allowed access to their benefits. Title III provides such access through an SBA guarantee program, which is designed to be self-sustaining."

Further, at page 13 of the same report:

> "Title III would enable small businesses to participate in the financing of pollution control equipment by issuance of industrial bonds as do big business. It is your Committee's opinion that a SBA insured tax exempt revenue bond program for small businesses is clearly the cheapest and most efficient method to provide pollution control financing needs. Creditworthiness, and a prime investment rating, would be assured. Rates, accordingly, would be low. Issue size, for liquidity purposes, would be large. Equity, in terms of major corporations, would be restored. And with a promise of a receptive institutional market for the bonds, the necessary incentive to investment bankers to assemble such issues would be fully and effectively provided."

Similarly, the above-referenced Senate report at pages 5 and 6 makes it clear that the utilization of tax exempt financing in conjunction with the pollution control program was contemplated by the Senate as well. For example:

> "Under section 404(b), commercial banks and investment dealers, functioning as originators of these financings, would identify those small businesses having difficulty obtaining financing for their pollution control expenditures. This identification would be done in cooperation with pollution control financing authorities, local enforcement agencies, trade associations, and local financing institutions. The originator would evaluate the creditworthiness of these small businesses for the purpose of screening out those firms which lack the resources necessary to meet the financial obligations of the program. Those firms not meeting the requirements of this first evaluation would be referred to other sources for financial assistance. The individual financial needs of those firms which meet the SBA's credit criteria, would be grouped together in a single bond issue. This grouping would be done on the basis of either a common geographical or industrial relationship. . .

> section 404 would enable small businesses to obtain the necessary long term, low-cost financing because: 1) industrial revenue bonds have an established institutional market; 2) the SBA lease insurance would make the bond's investment grade quality; 3) the tax exempt status of the bond offerings reduces the interest cost; and 4) the longer term bond scheduled provides for lower annual debt service."

Thus, we feel it is clear that SBA would be violating the intent of Congress as well as the letter of the statute and its regulations by reversing its previous administrative position with respect to the pollution control program and denying guarantees to contracts which are financed by tax exempt financing at this point. Instead, we suggest that a more prudent approach would be to publish in the Federal Register a notice of our intent to interpret our present statutory authority from the date of publication of the notice forward, to permit us to exclusively guarantee contracts which are financed by the proceeds of taxable bonds for the balance of Fiscal Year 1982. The notice would make clear that we will consider all applications which have been received prior to the date of publication of the notice, notwithstanding the taxable or nontaxable nature of the underlying financing, on a case-by-case basis,and that we will act upon those applications as we have acted upon them in the past pursuant to the regulations and guidelines governing the program.

If you have any further questions regarding this matter, please do not hesitate to contact this office.

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

April 22, 1983

TO : Honorable Carl Levin
Attn: Jim Callow

FROM : American Law Division

SUBJECT : Authority of OMB to Suspend SBA's Pollution Control Equipment Loan Guarantee Program for Tax-Exempt Issuances

At the direction of the Office of Management and Budget (OMB), the Small Business Administration (SBA) has ceased, since December 1981, its processing of applications for loan guarantees for contracts to purchase or lease pollution control equipment which are to be financed from the proceeds of tax-exempt bonds issued by public bodies. You have inquired whether this action by OMB is lawful. We conclude that serious legal questions may be raised as to OMB's authority to effectively suspend such a congressionally mandated program. In view of the sensitivity of this conclusion our analysis will be somewhat extended and proceed as follows: First, the statutory basis and nature of the program will be set forth and then the events which led to current cessation of the program will be detailed. Next, the legal issues raised will be identified and the relevant legal principles and case law will be analyzed to determine their applicability to the instant situation. Finally, the validity of OMB's action will be assessed in light of the circumstances and pertinent legal principles.

I. STATUTORY AND ADMINISTRATIVE BACKGROUND

Responding to the perceived needs of small businesses which were unable to procure low cost financing to meet the requirements of federal pollution laws, Congress in 1976 amended section 404 of the Small Business Investment Act of 1958[1] to authorize the Administrator of the Small Business Administration (SBA) to issue loan guarantees to insure payments by small businesses under purchase or lease contracts that secure pollution control bonds. The proceeds of such bonds may be either taxable or non-taxable to the holder.[2] The relevant portion of the statute provides:

> (b) The Administration may, whenever it determines that small business concerns are or are likely to be at an operational or financing disadvantage with other business concerns with respect to the planning, design, or installation of pollution control facilities, or the obtaining of financing therefor (including financing by means of revenue bonds issued by States, political subdivisions thereof, or other public bodies), guarantee the payment of rentals or other amounts due under qualified contracts. Any such guarantee may be made or effected either directly or in cooperation with any qualified surety company or other qualified company through a participation agreement with such company. The foregoing powers shall be subject, however, to the following restrictions and limitations:
>
> (1) Notwithstanding any other law, rule, or regulation or fiscal policy to the contrary, the guarantee authorized in the case of pollution control facilities or property may be issued when such property is acquired by the use of proceeds from industrial revenue bonds which provide the holders interest which is exempt from Federal income tax.

The Act was further amended in 1977 to establish a revolving fund for the program which would enable it to be self-sustaining, i.e., not to require congressional appropriations.[3] All monies received by the Administrator in the administration of the program are paid into the fund which is maintained in the U.S. Treasury and is available for purposes of the guarantee program without fiscal year limitation. All expenses and payments for the program (excluding administrative expenses) are paid from the fund. Available funds may be invested. The fund was initially capitalized by a $15,000,000 appropriation but has neither required nor received any further appropriations. The fund presently is capitalized at $53,943,838.[4/]

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[1] Pub. L. 85-699, 85th Cong., 2d Sess. (1958).

[2] Pub. L. 94-305, sec. 102., 94th Cong., 2d Sess. (1976), 15 U.S.C. 694-1(b) (1976).

[3] Pub. L. 95-89, 95th Cong., 1st Sess. (1977), 15 U.S.C. 694-2 (Suppl. IV, 1980).

SBA moved to implement its authority by initiating a notice and comment rulemaking proceeding[5/] pursuant to section 553 of the Administrative Procedure Act (APA).[6/] Following a 60-day public comment period, the agency issued its final rules[7/] which establishes as the policy of the agency the provision of guarantees for pollution control equipment acquired by use of the proceeds from tax-exempt industrial revenue bonds whenever possible.[8/] The regulation prescribes the substantive requisites for eligibility which include requirements that the small business applicant must be independently owned and operated, not dominant in its field, eligible under general SBA policy, have been in operation for at least five years, and have a history

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[4/] H. Rept. No. 98-21, 98th Cong., 1st Sess. 2 (1983), accompanying H. Res. 76, a resolution disapproving deferral of budget authority of the fund.

[5/] 42 F.R. 62012 (1977).

[6/] 5 U.S.C. 553 (1976). SBA has expressly waived any exemption that might have been available to it under 5 U.S.C. 553(a)(2). 13 C.F.R. 101.9 (1982).

[7/] 43 F.R. 33231 (1978), 13 C.F.R. Part 111 (1982).

[8/] 13 C.F.R. 111.2 (1982).

of profitable operations during any three of the five years preceding the date of application.[9] The regulation also sets forth the procedure for application,[10] the terms of the guarantee and fees required, and the guarantee limit ($5 million).[11] The regulation became effective on July 31, 1978, and to date has not been revoked or modified pursuant to the APA's informal rulemaking processes.

From the inception of the program, and consistent with the policy enunciated in its 1978 regulation, SBA has exclusively guaranteed contracts which were financed by the proceeds of tax-exempt state or local governmental bond issues. The effect of this policy was to open avenues of financing in money markets previously unavailable to small businesses. This was so because in the past, small businesses, because of their limited size and lack of investor recognition, could not obtain tax-exempt financing, a problem that is exacerbated by the non-productive nature of the pollution control equipment to be financed. The SBA guarantee of the contract between the small business and the issuer provided that recognition and opened the way for municipal bond market financing in the same way as large corporations. Briefly, the process works as follows: A public entity issues tax-exempt pollution control revenue bonds. The term of repayment of the bond is typically 20 to 25 years. The business enters into a contract with the issuer of the bonds stipulating that periodic payments in sufficient amounts to cover the interest payments to the bondholders, and to redeem the bonds as they mature, will be made by the small business. The ability of the small business to comply with the terms of the contract is guaranteed by SBA. The effect of this scheme is to make the bonds highly competitive on the bond market (they are rated AAA by Moody's). It also allows the small business to receive the necessary capital at low interest rates which lessens its often severe cash-flow problems. The interest rate differential, particularly in times of high rates, between taxable and tax-exempt bond has in practice made taxable bonds a non-viable financing alternative (assuming marketing problems are overcome).

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[9] 13 C.F.R. 111.4 (1982).

[10] 13 C.F.R. 111.5 (1982).

[11] 13 C.F.R. 111.7 (1982).

Between 1976 and 1981, SBA assisted 213 companies by guaranteeing $256 million in loans. During that period the program experienced only two defaults which resulted in payments of some $66,000 from the revolving fund. By means of workout agreements with the companies, however, SBA experienced no actual losses.

Since 1981, however, SBA has effectively ceased issuing guarantees in conjunction with tax-exempt financing. The actions which resulted in the cessation of its guarantee activity may be summarized as follows. The Carter Administration's budget submission for FY1982 requested $125 million in guarantee authority to operate the SBA program, an increase of $15 million over the previous FY. In March 1981 the Reagan Administration modified that request by asking for $95 million for FY1982. Congress, in the Omnibus Budget Reconciliation Act of 1981,[12/] rejected the request and increased SBA's authorized ceiling for guarantees for FY's 1982-1984 by providing:

12/ Pub. L. 97-35, 97th Cong., 1st Sess. (1981).

> For the programs authorized in sections 404 and 405 of the Small Business Investment Act of 1958, the Administration is authorized to enter into guarantees not to exceed $250 million. 13/

Thereafter, SBA made a revised budget request for the pollution control equipment program for FY's 1982 and 1983 of $250 million in each year. On November 5, 1981, the Office of Management and Budget (OMB) transmitted a credit control memorandum to SBA which directed SBA to expend no more than $50 million in guarantee authority on the pollution control program in FY1982. SBA protested and as a compromise OMB agreed to permit SBA to utilize $150 million of guarantee authority in both FY's 1982 and 1983 for the program. But SBA was directed not to use any of its guarantee authority in conjunction with tax-exempt financing after December 31, 1981. 14/

During this period Congress responded by directing SBA to maintain the program to at least the $175 million level for FY1982. 15/ Subsequently, Senate and House appropriations and oversight hearings have been held which have criticized OMB's actions. 16/

13/ *Id*. at sec. 1905.

14/ Such directives are contained in OMB documents entitled "Apportionment and Reapportionment Schedule", which are issued quarterly. The initial was contained in an apportionment document dated December 31, 1981. OMB argues that its authority to direct such program curtailments derives from its power to apportion an agency's appropriations under the Anti-Deficiency Act, 31 U.S.C. 665(c) & (d) (1976). The validity of this assertion is discussed in detail *infra* at pp. 22-27.

15/ See House SBA Hearings, *infra*, note 16, pp. 9, 76.

16/ See, e.g., Hearings Before the House Subcommittee on Energy, Environment, and Safety Issues Affecting Small Businesses of the Committee on Small Business, 97th Cong., 1st Sess. (Part I, November 4, 1981); 97th Cong. 2d Sess. (Part II, March 10 and 31, 1982) (hereinafter House SBA Hearings); Hearing on S. 499, A Bill to Require the SBA to Permit the Use of Tax-Exempt IRB Financing in Conjunction With the 503 Program, Senate Small Business Committee, 98th Cong., 1st Sess. (February 17, 1983) (hereinafter Senate SBA Hearing).

On February 1, 1983, the President submitted, pursuant to section 1013 of the Impoundment Control Act of 1974,[17] a proposal to defer $1 million from the Pollution Control Equipment Guarantees Revolving Fund.[18] A resolution of disapproval (H. Res. 76) was favorably reported out of the House Appropriations Committee[19] and passed by voice vote on March 10, 1983.[20] The practical effect of these actions and counteractions by the Congress and the Reagan Administration is that some $129 million of pollution control guarantee applications from 120 applicants have been frozen at various stages of that process.

Finally, in a variety of forums, congressional and administrative, SBA officials have made it expressly clear that but for OMB directives the agency would have continued issuing guarantees for tax-exempt issues.[21] OMB, together with the Treasury Department, on the other hand, have made it equally clear, in the same forums, that the injunction against the SBA guarantee program is the product of the Executive Branch's overall policy of containing budget deficits by stemming the loss of tax revenues which are said to result from the allowance of tax-exempt financing.[22]

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[17] 31 U.S.C. 1403 (1976).

[18] H. Doc. 98-15 accompanying deferral No. 86-64.

[19] H. Rept. No. 98-21, 98th Cong., 1st Sess. (1983).

[20] 129 Cong. Rec. H1123-24 (daily ed. Mar. 10, 1983).

[21] See House SBA Hearings, Part I, pp. 25-28; House SBA Hearings Part II, pp. 13-15; Senate SBA Hearing, pp. 31-39; Letter from James C. Sanders, Administrator, SBA to David Stockman, Director, OMB dated April 29, 1982 (requesting permission to issue guarantees in conjunction with tax-exempt bonds.

[22] See House SBA Hearings, Part II, pp. 51-67 (Testimony of John E. Chapoton, Assistant Secretary for Tax Policy, Treasury Department), 78 Letter from David Stockman to Chairman Bedell); from Joseph R. Wright, Jr., Deputy Director, OMB to James C. Sanders, Administrator, SBA dated May 26, 1982 (denying permission to issue guarantees in conjunction with tax-exempt bonds.)

II. LEGAL ISSUES THAT MAY BE RAISED

SBA's enabling legislation makes it clear that it was vested with the discretion to determine whether or not to guarantee pollution equipment control contracts which would be funded through the proceeds of tax-exempt bonds. The legislative history of the provisions is wholly in accord such a reading, and is, in fact, encouraging of the agency's utilization of the tax-exempt route even in the face of opposition by the Ford Administration. In this regard the House report accompanying H.R. 9056 states:

> The Administration has voiced opposition to this Title based upon its general opposition to tax exempt industrial bonds. Your Committee neither endorses nor rejects the concept of such bonds. But the fact is that such bonds are now a legal reality; they have been and are being issued, but only large firms are benefiting from them.
>
> Your Committee's position is that as long as tax exempt industrial bonds are a reality, small business as well as big business should be allowed access to their benefits. Title III provides such access through an SBA guarantee program, which is designed to be self-sustaining.
>
> * * *
>
> Title III would enable small businesses to participate in the financing of pollution control equipment by issuance of industrial bonds as do big business. It is your Committee's opinion that a SBA insured tax exempt revenue bond program for small businesses is clearly the cheapest and most efficient method to provide pollution control financing needs. Creditworthiness, and a prime investment rating, would be assured. Rates, accordingly, would be low. Issue size, for liquidity purposes, would be large. Equity, in terms of major corporations, would be restored. And with a promise of a receptive institutional market for the bonds, the necessary incentive to invest bankers to assemble such issues would be fully and effectively provided. 23/

23/ H. Rept. No. 94-519, 94th Cong., 1st Sess. 12, 13 (1975).

Similarly, the Senate report accompanying S. 2498 makes it clear that it contemplated utilization of tax-exempt financing in connection with the pollution control program being established:

> Under Section 404(b), commercial banks and investment dealers, functioning as originators of these financings, would identify those small businesses having difficulty obtaining financing for their pollution control expenditures. This identification would be done in cooperation with pollution control financing authorities, local enforcement agencies, trade associations, and local financing institutions. The originator would evaluate the creditworthiness of these small businesses for the purpose of screening out those firms which lack the resources necessary to meet the financial obligations of the program. Those firms not meeting the requirements of this first evaluation would be referred to other sources for financial assistance. The individual financial needs of those firms which meet the SBA's credit criteria, would be grouped together in a single bond issue. This grouping would be done on the basis of either a common geographical or industrial relationship...
>
> Section 404 would enable small businesses to obtain the necessary long-term, low-cost financing because: 1) industrial revenue bonds have an established institutional market; 2) the SBA lease insurance would make the bond's investment grade quality; 3) the tax exempt status of the bond offerings reduces the interest cost; and 4) the longer term bond scheduled provides for lower annual debt service. [24]

The congressional predilection in this regard may be seen as having even greater weight in light of the fact it marked a rare exception to the long-standing general statutory policy against exempting bond proceeds from federal taxation.[25]

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[24] S. Rept. No. 94-420, 94th Cong., 1st Sess. 5-6 (1975). See also H. Rep. No. 94-1115, 94th Cong., 2d Sess. 5 (1976) (Conference Report also indicating approval of guarantees of tax exempt financing).

[25] See, e.g., 31 U.S.C. 742a (1976).

Administrative regulations and practice confirm that the agency itself believes it has a choice of which financing mechanism to guarantee and had, until 1981, in fact preferred tax-exempt guarantees. Thus, SBA's 1978 regulations adopted to implement the pollution control program plainly indicate that the utilization of tax exempt financing is contemplated as a normal feature of administration of the program.

> § 111.2 Policy.
>
> It is the intent of Congress to assist existing Small Concerns including solid or liquid waste disposal concerns, which are or are likely to be at an operational or financing disadvantage with other business concerns with respect to the planning, design, or installation of pollution control Facilities, or the obtaining of financing therefor, by authorizing SBA to guarantee fully (100 percent), directly or in cooperation with others, the periodic payments due in connection with the purchase or lease of such Facilities under a Qualified contract. The guarantee shall be a full faith and credit obligation of the United States, and may be issued notwithstanding that the pollution control Facility is acquired by the use of proceeds from tax-exempt industrial revenue bonds. In those instances where revenue bond financing is uneconomic or is not practicable (e.g., for small amounts), or when the project may not qualify for tax-exemption, the Small Concern may seek financing assistance under SBA's pollution control (Small Business Investment Act, sec. 404, 15 U.S.C. 694-1), Air Pollution (Small Business Act, sec. 7(b)(5), 15 U.S.C. 636), or Water Pollution (Small Business Act, sec. 7(g)(1), 15 U.S.C. 636(g)(1)) Loan Programs.

26/

Indeed, prior to 1982 SBA never guaranteed a contract which was supported by taxable financing.

26/ 13 C.F.R. 11.2 (1982).

In view of this, three substantial questions arise: (1) Has OMB displaced SBA's discretionary authority in the area with its own? (2) If so, by what authority has it done so? (3) Assuming an authority in either OMB or SBA to alter the nature or direction of the program, has it been accomplished in accordance with the requirements of the Administrative Procedure Act or the principles of due process? We address each of these questions in turn.

A. Has OMB Displaced SBA's Discretionary Authority? In United States ex rel. Accardi v. Shaughnessy,[27] the Supreme Court held that when a federal officer is legally vested with discretionary authority, he may not be directed in the use of that discretion by a superior officer. The Court stated that "If the word 'discretion' means anything in a statutory or administrative grant of power, it means that the recipient must exercise his authority according to his own understanding and conscience."[28] Arguably, SBA's statutory freedom of choice of decision[29] was absent in the instant circumstances. In testimony before congressional committees SBA officials conceded that OMB had taken the policy decision out of their hands. Thus during questioning by the chairman of the House Subcommittee on

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[27] 347 U.S. 260 (1954).

[28] Id., at 266-67. In that case the Court held that the Attorney General could not direct the use of a subordinate's discretion, even where the Attorney General had himself granted the discretion to the subordinate and retained ultimate review of the decision for himself. See also United States v. Nixon, 418 U.S. 683, 696 (1974) citing Shaughnessy with approval.

[29] Standard dictionaries define discretion as "...3a: individual choice or judgment b: power of free decision or latitude of choice within certain legal bounds." Webster's Seventh New Collegiate Dictionary (1970); "... 2 freedom to judge or choose." World Book Dictionary (1977).

Energy, Environment and Safety Issues as to why there had been no appreciable growth in loan guarantees issued between FY's 1980 and 1981, the following colloquy with Acting Associate Administrator Edwin T. Holloway, Vincent A. Fragnito, Chief, Pollution Control Financing Division, and Peter F. McNeish, Deputy Associate Administrator for Investment, took place.

Mr. Holloway. The final figure that would be available as a program level was not really nailed down until late in the year. There was additional demand. There were additional requests in the pipeline that would have resulted in a higher program level had that been authorized.

Mr. Bedell. You mean it was not authorized by the Congress?

Mr. Holloway. Authorized and apportioned by the OMB.

Mr. Bedell. So the reason there was not very much of an increase in 1981 over 1980 was because OMB did not permit you to make those guarantees.

Mr. Holloway. That is correct.

Mr. Fragnito. Mr. Chairman, the total amount authorized for fiscal year 1981 was $180 million. That is approved, committed transactions.

Mr. Bedell. By the Congress?

Mr. Fragnito. By us. We had applications totaling $180 million that we could have used for fiscal year 1981.

Mr. Bedell. And OMB would not let you do it?

Mr. Fragnito. We had authority allocated by OMB at the $100 million level.

* * *

Mr. Bedell. We are talking about two different things. The Congress has authorized and the President has signed, if I understand it correctly, legislation authorizing $250 million. Apparently you did not think that was the case.

Mr. Holloway. I do not believe that the complete process of apportionment of that authority to us from the OMB has been completed.

Mr. Bedell. That is a different story, what OMB is doing. We have the legislative branch and the executive branch. The legislative branch, if I understand correctly, has authorized $250 million for this program. The President has signed such authorization.

Mr. Holloway. That is correct.

Mr. McNeish. Your statement is correct, Mr. Chairman, in terms of the authorization by the Congress. It has been signed into law by the President. The blockage point at this point in time in terms of effective apportionment or usage of those funds is in discussions at the level of OMB and the White House, and the question of their posture on Federal credit programs generally, which you alluded to in your opening statement, and the question of what approach the administration will take in recommending reduced levels in terms of budget cuts on a number of Federal credit programs, including this one.

In this interim period, we have only an authorized level, as Mr. Fragnito indicated, from OMB to utilize funds at this juncture to the extent of $40 million for the first quarter of this fiscal year.

Mr. Bedell. So the reality of the situation is that Congress has passed and the President has signed legislation authorizing $250 million; that you have requests outstanding of slightly er $0 million that you were unable to fill last year, $77.8 additional applications, and a survey indicates there is $21 also in the pipeline, for a total of $379 million, which sig exceeds the $250 million authorization; and that even tho gress passed it and the President signed it, OMB has told y you cannot guarantee over $40 million of that.

Mr. McNeish. You are missing one fact, Mr. Chairman; is, the administration has also submitted to the Congress recomndations for budget cuts in this program reducing the progr to the $95 million.

Mr. Bedell. Sorry. I did not mean to leave anything out. B as things stand, the President signed such legislation and OMB has told you you cannot spend it, even though the President signed the bill.

Mr. McNeish. In light of the President's recommendation to reduce the program levels, that is correct. It would seem foolhardy to manage a program at a $250 million level if the President intends to reduce the program to $95 million.

Mr. Bedell. You have complete freedom. If OMB had not said that, you could go right ahead and issue loan guarantees.

Mr. McNeish. The SBA does not have complete freedom on budget matters without OMB. It is a decision by this administration.

Mr. Bedell. They signed the bill.

Mr. McNeish. They have subsequently made a recommendation to reduce the program level through budget reductions to the level of $95 million.

Mr. Bedell. I guess we really get to the real issue of who it is that makes the determinations about where money is to be spent. At least most people think that Congress makes that determination, with the approval of the President, and the President had signed and agreed to this.

Mr. McNeish. Obviously, but that is ever-changing and not locked into stone. The President certainly did take that action. He has subsequently taken additional action. He has come to the Congress and asked them to reconsider the position. [30/]

[30/] House SBA Hearings, Part I, pp. 25, 26-8.

Mr. Holloway's testimony before the Senate Small Business Committee is even more straight forward:

> Senator Levin. I am reading your regulations.
>
> Mr. Holloway. Senator, as you may recall from the last hearings, it was made a matter of record at that time when I believe Senator D'Amato entered into the record a memorandum from the Office of Management and Budget that permitted us to continue the funding of the program, provide that we did not --
>
> Senator Levin. Mr. Holloway, I am reading to you from what I consider to be the laws of the land. I am familiar with that OMB memo.
>
> Mr. Holloway. Right.
>
> Senator Levin. Regulations are the laws of the land, and that law of the land is -- this was a regulation made pursuant to law, I presume, wasn't it?
>
> Mr. Holloway. I believe it was, Senator.
>
> Senator Levin. You did not act lawlessly when you adopted this regulation, did you?
>
> Mr. Holloway. No, sir.
>
> Senator Levin. You wouldn't do a thing like that Your regulation, made pursuant to the laws of the land and therefore part of the laws of the land, says that loans made with the proceeds of 503 debentures may be subordinated to such obligations. Now you are telling me that a memo from the OMB is now superior to this?
>
> Mr. Holloway. I am only telling you, Senator, that to commit the funds of the United States, I have to have an apportionment to do it from the Office of Management and Budget and to comply with all the terms and conditions of that apportionment.

Senator Levin. Do you take your directives from the Congress or the OMB?

Mr. Holloway. As far as the executive branch of the Government, my directives come from the White House.

Senator Levin. Therefore, if the OMB tells you you may not do something which the Congress says you may do, you follow the directive from the White House?

Mr. Holloway. I do not obligate money that is not apportioned to me by the OMB.

Senator Levin. If the law of the land says that you may do something and OMB says you may not, you take the OMB?

Mr. Holloway. They are a higher authority in the executive branch than I am, Senator, and I do --

Senator Levin. Have you received a legal opinion as to whether you are now acting lawfully or lawlessly? Ha your lawyer advised you on this issue?

Mr. Holloway. I don't have an opinion on that specific, narrow point, Senator. However, it is clear that I have no authority to commit the United States beyond the funding level that I am given apportionment, apportioned from the OMB and according to the terms and conditions of the apportionment.

Senator Levin. But for that directive by the OMB, I presume you would follow your own regulations?

Mr. Holloway. Yes, sir.

Senator Levin. You have not changed that regulation, have you?

Mr. Holloway. We have a proposal that is pending at OMB to change --

Senator Levin. However, you have not yet changed that regulation?

Mr. Holloway. It is not changed final, no, sir.

Senator Levin. It is not even changed proposed, is it?

Mr. Holloway. Yes, sir. It is pending at OMB. It is not in the Federal Register yet.

Senator Levin. No, I am talking about publishing a proposed regulation.

Mr. Holloway. It is not in the Federal Register yet.

Senator Levin. Now the Small Business Investment Act of 1958 says, "Notwithstanding any other law, rule or regulation, or fiscal policy to the contrary, a guarantee authorized in the case of pollution control facilities or property may be issued when such property is acquired by the use of proceeds from industrial revenue bonds which provide the holders interest which is exempt from Federal income tax." Are you familiar with that section?

Mr. Holloway. Yes, sir, I am familiar, Senator.

Senator Levin. That specifically says that you may issue such guarantees even though the interest is exempt from federal income tax. Is that right?

Mr. Holloway. Yes, sir.

Senator Levin. OMB has told you that you may not.

Mr. Holloway. The apportionment that I have does not permit me to obligate the funds of the United States on that basis, sir.

Senator Levin. The OMB has told you you may not.

Senator, does not permit me to do that.

Senator Levin. OMB wrote the apportionment.

Mr. Holloway. That is correct. They approved it.

Senator Levin. OMB told you you may not do somethi which Congress told you you may do. Isn't that what it reall comes down to?

Mr. Holloway. Senator, I can see that interpretation.

Senator Levin. Can you see any other interpretation?

Mr. Holloway. Yes, sir. I can see the interpretation that an official of the United States, I will not commit the funds of the United States outside the authority that I have.

Senator Levin. Of course, of course. I am saying, Do you see any other interpretation than OMB has told you you may not do something which the Congress has told you you may do?

Mr. Holloway. That is a fair interpretation, and I am in the executive branch.

Senator Levin. I appreciate that, and I know at the moment you appreciate that.

[Laughter.]

Senator Levin. I want to ask you a question. It is just a common-sense, direct question.

Mr. Holloway. Sure.

Senator Levin. Is it not clear that the OMB has in effect told you you may not do something which the Congress has told you you may do?

Mr. Holloway. That is correct.[31]

On April 29, 1982, the Administrator of SBA appealed OMB's decision to deny it guarantee authority for tax-exempt pollution control financings. The Administrator noted the hardship that applicants for tax-exempt guarantees were suffering as a consequence of delay in processing caused by OMB's injunction against such guarantees as well as the general detriment the entire program would suffer in changing its nature. He also expressed the view the OMB's directive had forced it to act "in apparent violation of the authorizing legislation and its own regulations concerning this program", citing an opinion of the agency's General Counsel. In the Administrator's opinion it was Congress' intent that "[t]he program was designed to allow small businesses to obtain access to the tax-exempt municipal bond markets." He concluded with a plea to be allowed to continue the program as before or, at a minimum, to complete processing or pending applicants who had not received "proper notice" of the termination of tax-exempt guarantee financing.[32] Thus, SBA's disposition was plainly to continue the program as it was prior to OMB's freeze and would have done so in the absence of the OMB directive. On May 26, 1982 OMB denied SBA's appeal, citing the Reagan Administration's overall policy against tax-exempt revenue financing and its view that some states "do not see a prohibition to their issuing taxable IRB's." OMB also denied permission to the agency to complete processing of pending applications since "the letter of the statute is permissive and the regulations do not interfere with the Administration's prerogative to exclude tax-exempt financing from the program"[33/]

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[31] Senate SBA Hearing, pp. 32-37.

[32] Letter from James C. Sanders, Administrator, SBA to David A. Stockman, Director, OMB, dated April 20, 1982.

On the basis of the foregoing, it would appear fair to conclude that OMB has substituted its judgment for that of the officials in whom Congress has expressly vested administrative discretion. It might be argued that all that has occurred in this situation is that OMB has expressed a strong policy judgment in the matter but has not taken the administrative machinery out of the agency official's hands and itself effected the final decision. Thus, it may be contended, as long as the agency itself has the last word or action, its discretion can be said to be preserved. However, this would seem to leave little substance to the Supreme Court's view of the nature of administrative discretion, which it saw as consisting of an official's exercise of "his authority according to his own understanding and conscience," or the common understanding of the term. Moreover, Administrator Sanders' letter of April 29 belies that he acted with any such volition; and the failure of the agency to repeal its own regulation reflecting a contrary policy after almost a year and a half is substantial evidence that SBA has not acted on its own.

[33/] Letter to James Sanders, Administrator, SBA from Joseph R. Wright, Jr., Deputy Director, OMB, dated May 26, 1982.

B. Does OMB Have Independent Authority to Act In The Matter?

Demonstrating that OMB has substituted its judgment for that of SBA does not conclude the matter if OMB can show it has an independent source of authority to so act. Three possible sources might be pointed to support such a position: First, the general governmental policy against federal agency support of tax-exempt issuances; second, the Antideficiency Act; and third, the authority of the President to supervise and coordinate the executive agencies of government to assure that the laws are faithfully and consistently administered.

1. Governmental Policy Disfavoring Guarantees of Tax-Exempt Financing.

OMB's denial letter of May 26, 1982 states that its position "is consistent with the [Reagan] Administration's efforts to preclude tax-exempt revenue financing especially in conjunction with an indirect Federal guarantee, as in this SBA program." That policy finds its source in a 1941 law[34/] and is currently being invoked by the Treasury Department, as chief spokesman of the Administration in this area, to justify its efforts to reduce budget deficits through control of the government's credit policy.[35/] That general statutory policy, however, finds an express exception in section 404(b) of the Small Business Investment Act of 1958.[36/] A Treasury Department official dealt with this apparent statutory conflict as follows:

[34/] 31 U.S.C. 742a (1976).

[35/] House SBA Hearings, Part II, pp. 37-67 (Testimony of John E. Chapoton, Assistant Secretary for Tax Policy, Treasury Department), 78 (letter from David Stockman, Director OMB, to Chairman Bedell).

[36/] 15 U.S.C. 694-1(b)(1) (1976).

> Mr. BEDELL. All I've got to do is repeat that exact statement to my audiences if I want to just absolutely prove my point, Mr. Chapoton.
>
> Well, all the chairman knows at this time is to plead with you to realize what is happening. I think the other thing that disturbed me somewhat is that you testified that allowing SBA guarantees for tax-exempt pollution control obligations is directly contrary to the policies expressed by Congress in those enactments. You're talking about a 1941 law—and in 1976, Congress passed legislation that clearly stated otherwise. Are you aware of that?
>
> Mr. CHAPOTON. Yes, I'm aware of that. There have been a number of acts, I think.
>
> Mr. BEDELL. If you're aware of that, why would you put in testimony only about the 1941 law and not put in what is the most recent legislation which clearly indicates that Congress does want this the other way? Why would you do that?
>
> Mr. CHAPOTON. I think the 1941 law was the starting point of a long standing Federal credit policy, and that policy has been reflected in numerous pieces of legislation since then, and I understand the argument that it conflicts with the SBA program that was adopted in the midseventies.
>
> Mr. BEDELL. Which would you think we should go by? The last law passed or the first law passed?
>
> Mr. CHAPOTON. From our policy standpoint, we start cutting back in these areas of Federal credit guarantees. We certainly would look to, and OMB did look to, a long standing administration and indeed, Government policy on Federal guarantee of tax exempts. Now, that obviously is in conflict now, but that is the policy that we followed and it is consistent with the policy that we followed all along.

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At best, the Treasury/OMB position appears to be that the general statutory policy is preferable and that statutory exceptions will be ignored. A better argument might be that since the 1976 provision is an exception to the general policy, it is to be narrowly construed. The Administration's position, however, leaves no area for possible action by SBA in the tax-exempt financing field. In that case, it is unlikely that a court called upon to rule with respect to the statutory conflict would deny the validity and continued efficacy of the 1976 exception.

37/ House SBA Hearings, Part II, p. 62.

2. The Antideficiency Act.

It would appear that the technical mechanism by which OMB has prevented SBA from fully utilizing its loan guarantee authority is the issuance of an Apportionment and Reapportionment Schedule pursuant to its authority under the Antideficiency Act.[38] Under that Act the Director of OMB has been assigned the task of apportioning and reapportioning appropriations of the Executive Branch. In order to assess the validity of OMB's exercise of this authority, it is necessary to understand the nature, purpose, and scope of the Act.

The Antideficiency Act is the linchpin of a complex of legislative solutions to deal with the problem of irresponsibility on the part of government officials entrusted with the duty of spending public monies properly and is intended to protect and preserve the congressional power of the purse.[40] It evolved in response to a history of executive agency disregard of congressional spending limitations,[41] which included making obligations in excess or in advance of appropriations; commingling funds which had different purposes; spending for unauthorized purposes; and spending appropriated funds in the first months of the fiscal year and effectively coercing deficiency or supplemental appropriations out of the Congress. In its present form, the underlying principle of the Act is that government should be a "pay as you go" operation. Officials are enjoined by its provisons not to make payments, or to commit the United States to make payments at some future time, for goods and services unless there is an available appropriation. The Comptroller General has summarized its purpose as follows:

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[38] 31 U.S.C. 665 (1976).

[39] 31 U.S.C. 665(d)(2) (1976).

[40] "No money shall be drawn from the Treasury but in consequence of appropriations made by law" U.S. Const., art I, sec. 9.

[41] See generally, "Principles of Federal Appropriations Law," U.S. General Accounting Office, chap. 5 (1982) (hereinafter Appropriations Treatise). See also, Fisher, Presidential Spending Power, 154-57, 229-38(1975).

> These statutes evidence a plain intent on the part of the Congress to prohibit executive officers, unless otherwise authorized by law, from making contracts involving the Government in obligations for expenditures or liabilities beyond those contemplated and authorized for the period of availability of and within the amount of the appropriation under which they are made; to keep all the departments of the Government, in the matter of incurring obligations for expenditures, within the limits and purposes of appropriations annually provided for conducting their lawful functions, and to prohibit any officer or employee of the Government from involving the Government in any contract or other obligation for the payment of money for any purpose, in advance of appropriations made for such purpose; and to restrict the use of annual appropriations to expenditures required for the service of the particular fiscal year for which they are made.' [42]

Under section 665(c)(1) and (d)(2) of the Act, all appropriations are required to be administratively apportioned by the Director of OMB so as to ensure their expenditure at a controlled rate which will prevent deficiencies from arising at the end of a fiscal year. Apportionment is also required to ensure that there is no curtailment of the activity for which the appropriation is made.[43] That is, the apportionment requirement is designed to prevent an agency from spending its entire appropriation before the end of the fiscal year and then putting Congress in a position in which it must either grant an additional appropriation or allow the entire activity to come to a halt. The goal of the process, in the words of the statute, is "to achieve the most effective and economical use" of appropriated monies. [44]

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[42] 52 Comp. Gen. 272, 275 (1962).

[43] 36 Comp. Gen. 699 (19$\overset{5}{8}$2). See also 38 Comp. Gen. 501 (1959).

OMB's apportionment authority, however, is not unlimited. It is bounded by the narrow and specific purposes of the Act of curbing agency fiscal irresponsibility and achieving the most economical and efficient use of appropriated monies. It is not meant to be a vehicle for direct or indirect alteration of the substantive ends for which Congress made the appropriations. In this regard ,for example, the Comptroller General found that OMB had abused its apportionment authority when it attempted to prevent the Securities Exchange Commission from hiring personnel which had been authorized by the Congress. In condemning such a use of the apportionment power the Comptroller General stated:

> [T]he apportionment power may not lawfully be used as a form of executive control or influence over agency functions. Rather, it may only be exercised by OMB in the manner and for the purposes prescribed in 31 U.S.C. §665--*i.e.*, to prevent obligation or expenditure in a manner which would give rise to a need for deficiency or supplemental appropriations, to achieve the most effective and economical use of appropriations and to establish reserves either to provide for contingencies or to effect savings which are in furtherance of or at least consistent with, the purposes of an appropriation.
>
> As thus limited, the apportionment process serves a necessary purpose--the promotion of economy and efficiency in the use of appropriations. [45]

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[44] 5 U.S.C. 665(c)(1) (1976).

[45] B-163628, January 4, 1974.

Thus, while the appropriations of executive departments and agencies, including independent regulatory agencies, are subject to apportionment by OMB, OMB may not lawfully use its apportionment power to compromise the independence of those agencies to pursue goals and carry out tasks clearly committed to them by the Congress.

In view of the foregoing two questions arise: Is SBA's loan guarantee authority subject to the apportionment process at all? Assuming it is, has OMB lawfully exercised that power?

The Antideficiency Act's apportionment process is specifically limited to "appropriations, funds, and authorizations to create obligations by contract in advance of appropriations." The process therefore is concerned with the allocation of budget authority, a term that is statutorily defined to exclude loan guarantees: "The term 'budget authority' means authority provided by law to enter into obligations which will result in immediate or future outlays involving Government funds, except that such term does not include authority to ensure or guarantee the repayment of indebtedness incurred by another person or Government."[46] It is well recognized that loan guarantees are contingent liabilities, a conditional commitment that may become an actual liability because of a future event beyond the control of government. Thus when a loan is guaranteed, no obligation of funds occurs until the Federal government becomes legally required to honor its guarantee, if ever, upon the default of the borrower. Then, a liquidating appropriation is made, if necessary. This is in contrast with contract authority, where the contract authority itself counts as budget authority whereas the liquidating appropriation that must be subsequently made does not.[47] The General Accounting Office has succinctly explained the nature of loan guarantees as follows:

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[46] 31 U.S.C. 1302(a)(2) (1976); see also Appropriations Treatise at 2-2, 4-4.

> The making of a loan guarantee does not involve an actual expenditure of Federal funds. The expenditure is made if and when the agency is required to pay on the guarantee, i.e., when the borrower defaults, at which time the agency must seek a liquidating appropriation. Congress has little choice but to appropriate the necessary funds since the guarantee is generally backed by the full faith and credit of the United States. This is an example of so-called "backdoor spending" --expenditures which are effectively beyond the control of the appropriations process.
>
> When the original guarantee is made, the extent to which a liquidating appropriation may be needed cannot be known. Therefore, the making of the guarantee does not create budget authority. Budget authority is created by the liquidating appropriation. The Congressional Budget Act of 1974 recognizes this concept in the definition of "budget authority" by providing that the term "does not include authority to insure or guarantee the repayment of indebtedness incurred by another person or Government." 31 U.S.C. § 1302(a)(2). * Thus, most Federal loan guarantee programs lie outside the Federal budget.[48]

Thus loan guarantees do not appear to be encompassed with the apportionment authority of OMB. Indeed, a closely similar question was presented to the Comptroller General regarding the practice of the Economic Development Administration, which had statutory authority to guarantee certain loans, of obligating amounts equal to 25 percent of the total loans it guaranteed each year to serve as a contingency reserve against possible losses. The question presented was whether the practice violated the Antideficiency Act if the face amount of the loans exceeded available appropriations. The Comptroller found no violation even though it was possible that in the future a deficiency appropriation might be needed since there was specific statutory authority for the loan guarantee program and Congress had acquiesced in this funding method.[49] In sum, the General Accounting Office has concluded that "Generally, loan guarantees do not present Antideficiency Act problems as the statutory authority to guarantee loans is viewed as authority to incur obligations in advance of appropriations."[50]

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[47] Appropriations Treatise, 2-3.

[48] Ibid., at 14-4 (footnote omitted).

In light of these established principles and precedents, a serious question may be raised whether OMB's exercise of its apportionment power to restrict SBA to utilization of only $150 million of its $250 million loan guarantee authorization level is lawful since it does not involve appropriated monies.

Even assuming loan guarantee levels may be viewed as falling within scope of OMB's authority, it may be questioned whether the particular exercise here was proper. As may be recalled, OMB's apportionment action not only diminished the guarantee limit from $250 to $150 million, it also restricted the remaining authority to guarantees of taxable bond issues, the effect of which has been to bring the program to a halt.[51] As has been previously indicated, OMB's sole rationale for this action is to effectuate the Reagan Administration's overall policy of cutting back on this credit mechanism throughout the government as a means of enhancing tax revenues to offset budget deficits. The action is therefore plainly

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49/ B-133170-O.M., December 22, 1977.

50/ Appropriations Treatise, 5-18. SBA's situation would appear considerably stronger than EDA's since the establishment of the revolving fund in 1977 erases any doubt about its authority to use its current method of funding.

51/ See House SBA Hearings, Part II, pp. 10-11.

intended to achieve a substantive change in the program that is at apparent odds with Congress' expressed intentions, and contrary to the limited purposes of the Antideficiency Act of achieving economy and efficiency through controlled use of appropriated funds.[52]

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[52] A further, related question may be raised as to the use of the deferral process of the Impoundment Control Act to achieve the $100 million reduction in the congressionally authorized loan guarantee level. As was related in the text, *supra* p. 7, on February 1, 1983, the President proposed deferral of $1 million which, he stated, "represents the provision for anticipated losses that is associated with a reduction in pollution control guarantees of $100 million." The theory seems to be that since the revolving fund received an initial $15 million appropriation, and since experience has shown that each $1 million in reserve will cover the possible losses that might be incurred in each $100 million of guarantees, an impoundment of that amount should be deemed a deauthorization of $100 million in authority. Several problems seem to be raised by this theory. First, for the same reason that loan guarantees are not covered by the Antideficiency Act, they are not covered by the Impoundment Control Act - they are not budget authority. The fact that some appropriated funds are in the revolving fund ignores the fact that Congress contemplated that the fund would grow larger with nonappropriated funds which would provide a cushion for further guarantees, which has in fact occurred. Thus deferral of a portion of the original appropriation should not in itself affect the level of the current authorization, particularly in view of the fact that the fund is now almost four times greater than its original capitalization. Moreover, it would be a backdoor way of getting at the substance of guarantee programs, which clearly was not intended by the Congress. On the other hand, if such a deferral is viewed as an effective and lawful method of achieving a reduction of the guarantee level, by the same token a congressional disapproval of the deferral should have the effect of restoring the originally authorized level. OMB, arguably, cannot have it both ways. The deferral proposal was disapproved by the House on March 10, 1983. We are not aware if SBA's guarantee level has been restored as a consequence.

3. Presidential Authority to Supervise and Coordinate the Execution of Policy of Subordinate Officials

It may be contended that OMB's authority derives directly from its position as chief managerial agent for the President and that as a consequence it can, when properly authorized by the Chief Executive, exercise the President's constitutional authority to "supervise and guide" subordinate executive officers in carrying out their statutory duties. The argument might run as follows. Article II of the Constitution reposes all executive power in a single Chief Executive,[53] and charges him to "take Care that the Laws be faithfully executed."[54] It also provides the means for executive control of administration. By vesting the entire "executive power" in the one federal officer with a national constituency, the framers accommodated the twin notions of accountability and efficiency. The sparse but important provisions that follow develop lines of authority reflecting the competing claims of administrative necessity and separation of powers. The President can appoint executive officers[55] and require them to report to him so that he can determine whether the laws are being "faithfully executed.[56] The ability to require reports necessarily implies the right to confer with those officers. The President in turn must periodically report to Congress concerning the progress of the administrative operation and may suggest further legislative action. This scheme implies operational oversight and management of the administrative process, if not some degree of substantive control, and suggests a line of authority that runs from Congress to the President rather than from Congress to subordinate executive officers.

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[53] U.S. Constit., art. II, sec. 1.

[54] U.S. Constit., art. II, sec. 3.

[55] U.S. Constit., art. II, sec. 2, cl. 2.

[56] U.s. Constit., art. II, sec. 2.

Substantial support for the foregoing conception of executive power over administration may be said to derive from the Supreme Court's landmark decision in Myers v. United States.[57] The "take Care" clause, as construed in Myers may be seen to authorize the President, as head of the Executive Branch, to "supervise and guide" executive officers in carrying out the statutes under which they act so that there can be some measure of uniformity in the interpretation and execution of the diverse laws enacted by the Congress. A denial of such guidance from the sole officer vested with executive power under the Constitution could result in confusion and inconsistency amongst government agencies. While it may be conceded that Congress may so delimit a delegation of authority to a subordinate official as to preclude presidential supervision of decisionmaking, such cases are rare, and it must be presumed that when Congress delegates broad decisionmaking authority to heads of non-independent agencies, it is aware that they are removable at the will of the President and thus it would be anomolous to believe that Congress would make such delegations with a lack of understanding of the existence of that control relationship. From these premises, then, it could be concluded that the standard to be applied for determining the permissible extent of presidential guidance and supervision is to be based on the degree of displacement of subordinate officer discretion. In an analogous situation, involving the assertion of presidential control of agency rulemaking by means of executive order, the Justice Department's Office of Legal Counsel formulated the applicable standard as follows: "[S]upervision is more readily justified when it does not purport wholly to displace, but only to guide and limit, discretion which Congress has allocated to a particular subordinate official. A wholesale displacement might be held inconsistent with the statute vesting authority in the relevant official."[58]

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[57] 272 U.S. 52 (1926).

Close analysis of the foregoing argument, however, reveals that the inferences drawn from the constitutional text are neither so compelling nor clear as they first appear, nor does it comport with actual historical practice or authoritative constitutional interpretations spanning almost two centuries. It is well understood that, notwithstanding their experience under the Articles of Confederation, the framers did not intend the presidency to be an institutional competitor to the Congress. Arguably, they did not conceive of the President as an administrative manager with a general power to control the acts of executive officers.[59] This view also

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[58] House Committee on Energy and Commerce, "Presidential Control of Agency Rulemaking: An Analysis of Constitutional Issues That May Be Raised by E.O. 12291", 81 (Committee Print 97-0, June 15, 1981).

[59] "[I]t was undoubtedly intended that the President should be little more than a political chief; that is to say, one whose function should, in the main, consist in the performance of those political duties which are not subject to judicial control. It is quite clear that it was intended that he should not, except as to these political matters, be the administrative head of the Government with general power of directing and controlling the acts of subordinate Federal administrative agents." 3 W. Willoughby, The Constitutional Law of the United States 1479-80 (2d ed. 1929). *See* F. Goodnow, Comparative Administrative Law 51-54 (1893); Corwin, *The Steel Seizure Case: A Judicial Brick Without Straw*, 53 Colum. L. Rev. 53 (1953); Jaffee, *Invective and Investigation in Administrative Law*, 52

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draws support from the language of article II. The vesting of "executive power" in the President may locate the situs of power but it does not define its content; the "take Care" clause does not say that the President will execute the laws; and the ability to require written reports from department leads on their activities does not naturally lead to an inference of power to direct the activities of those who report. The wording may thus suggest oversight of execution by others rather than direct execution by the President. The idea that power over administrative decisionmaking derives from the President's role as head of the executive branch or inheres in the concept "executive power", moreover, is inconsistent with a written constitution establishing divided, balanced, limited government.

A brief review of historical and legal practice and precedent underlines the preeminent role Congress was meant to play in the determination of domestic policy. According to the prevailing view, the framers intended the constitutional role of the Chief Executive, at least in domestic affairs, to be ancillary to that of the legislature. They believed that the President would be a managerial agent for the legislature rather than an independent source of domestic policy.[60] This view is evidenced by a

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(continued) Harv. L. Rev. 1201, 1203, 1238 (1939); Karl, *Executive Reorganization and Presidential Power*, 1977 Sup. Ct. Rev. 1, 10-11 ("Nor did [the framers] conceive of the presidency as an institutionalized representation of popular will distinct from, let alone capable of opposition to, the will expressed by the legislature."); Zamir, *Administrative Control of Administrative Action*, 57 Calif. L. Rev. 866, 869-70 (1969); Rosenberg, Beyond the Limits of Executive Power: Presidential Control of Agency Rulemaking Under E.O. 12,291, 80 *Mich. L. Rev*. 193, 202-209 (1981) (hereinafter "Beyond the Limits").

[60] *See* note 59 *supra* and accompanying text.

number of contemporaneous sources. Statutes enacted by the earliest Congresses, for example, reveal an assumption that Congress, not the President, should direct the operation of domestic agencies, and that presidential control over the execution of domestic laws was purely a matter of legislative authorization. In establishing the Departments of Foreign affairs,[61] War,[62] and the Navy,[63] Congress recognized that the President should have full control over those officers who would perform highly sensitive and political functions that the Constitution explicitly vests in the Chief Executive -- such as the conduct of foreign affairs and the command of the military. The statutes creating those departments explicitly empowered the President to direct and control their activities. Provision for presidential direction, however, was conspicuously absent in the statutes creating domestic departments such as the Treasury,[64] the Post Office,[65] and the Interior Department.[66] The Treasury Department statute, for example, did not even mention the President; it required the Secretary to report to Congress "and generally perform all such services relative to the finances, as he shall be directed to perform."[67] Such direction, the context makes clear, was to come from Congress, not the President. Indeed, for a significant period in our early history, the President did not see departmental budget estimates before the Treasury Department transferred them to

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[61] Act of July 27, 1789, ch. 4, § 1, 1 Stat. 28.

[62] Act of Aug. 7, 1789, ch. 7, § 1, 1 Stat. 49.

[63] Act of Apr. 30, 1798, ch. 35, § 1, 1 Stat. 553.

[64] Act of Sept. 2, 1789, ch. 12, § 2, 1 Stat. 65, 66.

[65] Act of May 8, 1794, ch. 23, § 3, 1 Stat. 357.

[66] Act of Mar. 3, 1849, ch. 108, § 1, 9 Stat. 395.

[67] Act of Sept. 2, 1789, ch. 12, § 2, 1 Stat. 65, 66.

Congress, and the Secretary recommended tax policy directly to Congress.[68/] Similarly, the Postmaster General was given detailed discretionary duties with no suggestion that he was to be under other than congressional direction in performing these tasks.[69/]

The opinions of Attorneys General throughout the nineteenth century echo the view that the "take Care" clause does not authorize the President to control subordinate officials in the exercise of their statutory discretion. For example, when pensioners tried to appeal the Comptroller's decision regarding the level of veterans' pensions directly to the President, Attorney General Wirt advised that the Comptroller's statutory authority was exclusive:

> If the laws, then, require a particular officer by name to perform a duty, not only is that officer bound to perform it; but no other officer can perform it without a violation of the law; and were the President to perform it, he would not only be taking care that the laws were faithfully executed, but he would be violating them himself. 70/

[68/] L. White, The Jacksonians 78 (1954); L. White, The Federalists 326 (1948).

[69/] W. Willoughby, *supra* note 59, at 1480. Professor Goodnow remarked about this unusual administrative organization as follows:

> In the United States, the original conception of the head of department was that of an officer stationed at the center of the government who might have, it is true, in many cases the power of appointment and removal, but who was not supposed to direct the actions of the subordinates of his department. . . . The conception of a hierarchy of subordinate and superior officers was very dim if it existed at all. F. Goodnow, *supra* note 59, at 136-37.

[70/] 1 Op. Atty. Gen. 624, 625-26 (1823).

The Constitution of the United States requires that the laws be faithfully executed; that is, it places the officers engaged in the execution of the laws under his general superintendence; . . . But it never (continued)

In the same vein, Attorney General Mason concluded in 1846 that the President's power to ensure that his subordinates "faithfully" execute their statutory duties does not confer on him "the power of correcting, by his own official action, the errors of judgment of incompetent or unfaithful subordinates."[71] Other Attorneys General applied this rule to a wide variety of situations where a subordinate was directly vested with authority by Congress,[72] so that, by 1884, Attorney General Brewster could inform the President of a "well settled" general rule: "it has repeatedly been held that the observance of your constitutional duty of taking care that the laws be faithfully executed does not of itself warrant your taking part in the discharge of duties devolved by law upon an executive officer."[73]

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> could have been the intention of the Constitution, in assigning this general power to the President . . . that he should in person execute the laws himself. . . . The Constitution assigns to Congress the power of designating the duties of particular officers: the President is only required to take care that they execute them faithfully. . . . He is not to perform the duty, but to see that the officer assigned by law performs his duty *faithfully* — that is, *honestly*: not with perfect correctness of judgment, but *honestly*.

Id. at 625-26 (emphasis in original).

[71] 4 Op. Atty. Gen. 515, 516 (1846).

[72] For example, the President was told that he could not interfere with a patent decision, 13 Op. Atty. Gen 28 (1869), and that he had no authority to review a department head's decision concerning the lowest bidder on a contract, 6 Op. Atty. Gen. 226 (1853).

[73] 18 Op. Atty. Gen. 31, 33 (1884). *See* 1 Op. Atty. Gen. 624 (1823); 1 Op. Atty. Gen. 705 (1825); 2 Op. Atty. Gen. 480, 481 (1831); 2 Op. Atty. Gen. 507, 508 (1832) (Comptroller's decision "is conclusive upon the executive branch of government"); 2 Op. Atty. Gen. 544 (1832); 5 Op. Atty. Gen. 630, 635 (1852) (presidential interference "would be a usurpation on the part of the President, which the accounting officers would not be bound to respect" unless Congress expressly ordered them to do so); 11 Op. Atty. Gen. 14 (1864);

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The original view of the limited nature of presidential control over the discretionary actions is confirmed by contemporaneous judicial precedent as well. The first of these, Gilchrist v. Collector of Charleston,[74/] was heard in May 1808 by Supreme Court Justice Johnson, sitting on circuit in the District of South Carolina. The case involved section 11 of the Act of April 25, 1808 which had vested in customs collectors the authority "to detain any vessel ostensibly bound with a cargo to some other port of the United States, whenever in their opinions the intention is to violate or evade any of the provisions of the acts laying an embargo, until the decision of the President of the United States be had thereupon." President Jefferson interpreted this authority very broadly and ordered the Secretary of the Treasury "to recommend to every collector to consider every shipment of provisions, lumber, flaxseed, tar, cotton, tobacco, etc., enumerating the articles, as sufficiently suspicious for detention and reference here." Shortly, in accordance with Jefferson's criteria, a vessel was detained in Charleston, despite the personal belief of the collector that its destination was as stated and that the owners did not intend to break the embargo. The shipowner applied for a writ of mandamus to compel issuance of a clearance. Justice Johnson granted the writ, holding that the discretionary authority vested

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13 Op. Atty. Gen. 28 (1869); 15 Op. Atty. Gen. 94, 101-02 (1876). The opinions are not unanimous, however. See 7 Op. Atty. Gen. 453, 469-70 (1855). In Attorney General Cushing's view, a denial of the power of presidential direction would allow Congress to "so divide and transfer the executive power as utterly to subvert Government." The opinion was called "extreme" by a prominent early commentator, F. Goodnow, The Principles of Administrative Law of the United States 81 (1905).

[74/] 10 F. Cas. 355 (C.C.D. S.C. 1808) (No. 5,420).

in collectors by the legislation could not legally be altered by an instruction of higher executive officials. "[T]he act of Congress does not authorize the detention of this vessel."[75] Without the sanction of law, Johnson opined, "the collector is not justified by the instructions of the executive, in increasing restraints upon commerce. . . ."[76]

Next, in Kendall v. United States,[77] a statute directed the Postmaster General to pay a group of individuals who had delivered the mail for a number of years an amount determined by the Solicitor. The Postmaster General, apparently at the express direction of the President, refused to pay the full amount that the Solicitor had found owing. The Supreme Court, viewing the Postmaster General's duty to pay the full amount as ministerial rather than discretionary, held that the President had no authority to direct the Postmaster General's performance of his statutory duty. Despite the Kendall Court's narrow holding, key passages in the opinion reflect the nineteenth-century notion that the President may not direct the manner in which executive officers carry out their discretionary functions. Where Congress has imposed upon an executive officer a valid duty, the Kendall Court declared, "the duty and responsibility grow out of and are subject to the control of the law, and not to the direction of the President."[78] Underlying the Court's rejection of the contention that the "take Care" clause carries with it the power to control executive officials was a strong desire to avoid "clothing the President with the power entirely to control the legislation of Congress."[79] Other early cases, like Kendall, also reflect the primacy of Congress in domestic affairs.[80] Congressional enactments, legal opinions of the various Attorneys General, and early judicial precedent thus establish that the President's role in the scheme of government established by the Constitution for more than a century of our nation's existence was that of a managerial agent for the legislature.[81] This prevailing view was premised on the assumption that presidential power was not essentially constitutionally based, but emanated from the legislative will, an assumption that traced its roots to the reasons for founding the Republic.[82] This view, moreover, carries with it the concomitant notion that presidential efforts to control the administrative actions of subordinate officers must find their bases in explicit constitutional provisions, express statutory enactments, or the clearest of implications from a congressional mandate or course of practice. The lack of congressional prohibition is, under this view, insufficient in itself to support executive power to control administrative discretion, even indirectly.

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[75] Ibid., at 357.

[76] Ibid.

[77] 37 U.S. (12 Pet.) 524 (1838).

[78] 37 U.S. (12 Pet.) at 610.

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[79] 37 U.S. (12 Pet.) at 613.

[80] See United States v. Grimaud, 220 U.S. 506, 516 (1911) (holding Secretary of Agriculture to be an agent of Congress in promulgating "administrative" rules); United States v. Perkins, 116 U.S. 483 (1886) (holding that where Congress vests the power of appointment in some official other than the President, it can regulate and restrict the manner of removing that appointee); Ex Parte Merryman. 17 F. Cas. 144, 149 (C.C.D. Md. 1861) (No. 9487) (Taney, C.J.) ("The only power . . . which the President posesses, where the 'life, liberty or property' of a private citizen are concerned, is the power and duty . . . 'that he shall take care that the laws shall be faithfully executed.' He is not authorized to execute them himself, or through agents or officers, civil or military, appointed by himself, but he is to take care that they be faithfully carried into execution."). The continuing validity of Perkins was affirmed in Myers v. United States, 272 U.S. 52, 127 (1926).

[81] As late as 1885, Woodrow Wilson could suggest in his Congressional Government that the presidency was at best a ceremonial and symbolic office in need of executive and administrative support from a reorganized Congress. See Zamir, supra note 59, at 871-73.

[82] See Karl, supra note 59, at 11.

While the President's authority directly to control his subordinates' performance of specific statutory duties occupied the attention of legal scholars and the courts in the nineteenth century, twentieth-century judicial precedents address a more indirect means of influence: the President's power to remove subordinate officials. Myers v. United States,[83] the leading case, held unconstitutional a statute providing that postmasters appointed by the President with the Senate's consent shall hold office for four years unless "removed by the President by and with the advice and consent of the Senate."[84] The President's responsibility to "take Care that the Laws be faithfully executed," the Court reasoned, demands that he have qualified authority to remove as well as to appoint subordinate officials.[85] Chief Justice Taft's majority opinion has been read as discerning broad supervisory power vested in the President by article II: The President, he concluded, must have the authority to "supervise and guide" at least some decisions of subordinate officers "to secure that unitary and uniform execution of the laws which Article II . . . evidently contemplated in vesting general executive power in the President alone."[86/]

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[83] 272 U.S. 52 (1926).

[84] 272 U.S. at 107 (quoting Act of July 12, 1876, ch. 179, § 6, 19 Stat. 80, 81).

[85] 272 U.S. at 117.

Reliance on Myers in the instant situation would be misplaced. The indirect power of removal differs significantly from OMB's action divesting SBA of its authority to issue guarantees for tax-free financing, and the Court's opinion nowhere goes so far as to hold that the President may direct the outcome of all decisions specifically committed by statute to a subordinate. The Court carefully distinguished the "ordinary duties of officers prescribed by statute" from those duties "so peculiarly and specifically committed to the discretion of a particular officer as to raise a question whether the President may overrule or revise the officer's interpretation of his statutory duty in a particular instance."[87/] Because the former duties "come under the general administrative control of the President," he may properly "supervise and guide" their performances.[88/] But Taft's opinion makes clear that the Chief Executive's power to "supervise and guide" his subordinates in the conduct of "ordinary duties"[89/] prescribed by statute does not extend to the decisionmaking functions committed by law to his

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[86/] 272 U.S. at 135.

[87/] 272 U.S. at 135.

[88/] 272 U.S. at 135.

[89/] The structure of this critical paragraph supports an argument that by "ordinary duties" Taft meant ministerial tasks or purely administrative duties not involving substantive decision-making since that passage is immediately followed by passages that clearly set apart rulemaking and adjudicatory functions. If so, the power to "supervise and guide" is of minimal substance.

subordinates' discretion. The President may remove a subordinate for negligent or inefficient use of that discretion; he may not, however, exercise his removal power before the subordinate has exercised the personally committed discretion.[90]

This requirement is not an empty procedural nicety. Although the President may remove an officer for a particularly offensive decision, he obviously cannot use the removal power to exert control over all administrative decisionmaking. The threat of removal, of course, gives the President great influence, but the decision that prompted the removal remains unaltered, and perhaps unalterable,[91] until a new appointee reverses the offensive action.[92] After-the-fact removal, moreover, gives Congress notice of the dispute and an opportunity to clarify its intent on the matter or to refuse to confirm a new nominee to an advice and consent position. Limiting the President to after-the-fact removal thus partially prevents secret or undue Executive influence in an area committed to a particular subordinate's discretion.

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[90] "Of course there may be duties so peculiarly and specifically committed to the discretion of a particular officer as to raise a question whether the President may overrule or revise the officer's interpretation of his statutory duty in a particular instance. Then there may be duties of a quasi-judicial character imposed on executive officers and members of executive tribunals whose decisions after hearing affect interests of individuals, the discharge of which the President cannot in a particular case properly influence or control. But even in such a case he may consider the decision after its rendition as a reason for removing the officer, on the ground that the discretion regularly entrusted to that officer by statute has not been on the whole intelligently or wisely exercised." 272 U.S. at 135.

[91] Due process, for example, may prevent the withdrawal of a property right granted.

[92] The difficulties that may be encountered, and the occasional inefficacy of the use of the removal power to alter the course of discretionary decision-making, was dramatized in the aftermath of the Saturday Night Massacre. See Nader v. Bork, 366 F. Supp. 104 (D.D.C. 1973) (holding that Acting Attorney General Bork had illegally dismissed the Watergate prosecutor).

Reliance on Myers is misplaced for a second reason as well: More recent cases have greatly limited the removal power that the Court once recognized. Distinguishing between purely executive officials such as the postmaster in Myers and officials who, while titularly within the executive branch, perform quasi-judicial or quasi-legislative functions, the Court has held that the President may not remove the latter type of official without cause. In Humphrey's Executor v. United States,[93] the President had removed a member of the Federal Trade Commission without cause despite a statutory provision that precluded removal except for "inefficiency, neglect of duty, neglect of duty, or malfeasance in office." In rejecting the idea of an illimitable presidential removal power, the Court emphasized the distinction between officials who performed purely executive tasks and those who carried out rulemaking and adjudication. "[A]n administrative body created by Congress to carry into effect legislative policies," the Court declared, "cannot in any proper sense be characterized as an arm or eye of the executive."[94]

The most recent removal case, Wiener v. United States,[95] reiterated the Humphrey's Court's distinction between purely executive and other types of administrative officials. The Wiener Court held that the President lacked the authority to remove a member of the War Claims Commission even though the Commission's founding statute had no removal provision. Because the official performed adjudicative tasks more closely allied to the judicial than the executive power, the Court reasoned that Congress intended to deny the President the power of removal. Humphrey's and Wiener thus teach that the scope of presidential authority depends on the agency function that the President seeks to control. Where that function is legislative or judicial in nature, authority for presidential control cannot be implied from the Constitution.

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[93] 295 U.S. 602 (1935).

[94] 295 U.S. at 628.

[95] 357 U.S. 349 (1958).

Two post-Myers and Humphrey's Supreme Court rulings also confirm the ability of Congress to protect the discretion of subordinate officers from presidential interference. In United States ex rel. Accardi v. Shaughnessy[96/] the Court held that when a federal officer is legally vested with discretionary authority, he may not be directed in the use of that discretion by a superior officer. The Court stated that "If the word 'discretion'-means anything in a statutory or administrative grant of power, it means that the recipient must exercise his authority according to his own understanding and conscience."[97/] The Court then held that the Attorney General could not direct the use of a subordinate's discretion, even where the Attorney General had himself granted the discretion to the subordinate and retained ultimate review of the decision for himself.

[96/] 347 U.S. 260 (1954).

[97/] Ibid., at 266-67.

Accardi was subsequently relied on by the Court in United States v. Nixon.[98] There the Court held that the Watergate Special Prosecutor could sue the President under a regulation issued by the Attorney General which defined the Special Prosecutor's authority and specifically gave him authority to contest the assertion of executive privilege. The Court stated:

> Here, as in Accardi, it is theoretically possible for the Attorney General to amend or revoke the regulation defining the Special Prosecutor's authority. But he has not done so. So long as this regulation remains in force the Executive Branch is bound by it, and indeed the United States as the sovereign composed of the three branches is bound to respect and enforce it. Moreover, the delegation of authority to the Special Prosecutor in this case is not an ordinary delegation by the Attorney General to a subordinate officer; with the authorization of the President, the Acting Attorney General provided in the regulations that the Special Prosecutor was not to be removed without the "consenus" [sic] of eight designated leaders of Congress. 99/

In sum, it is apparent that Supreme Court rulings in the context of the exigencies of twentieth century governance have not diluted to any significant extent the historic limitations on the exercise of Executive power over administrative decisionmaking. Thus it appears clear that there is neither express nor implied constitutional authority in the President or his delegate, OMB, to displace the discretion vested by Congress in SBA. The legal theory necessarily underlying that action would encompass and envelop all official discretion not specifically excepted by statute. This appears to plainly ignore the intent of the framers and the teachings of the Supreme Court.

98/ 418 U.S. 683 (1974).

99/ Ibid., at 696 (footnotes omitted).

c. Has SBA Complied With the Requirements of the Administrative Procedure Act and Principles of Due Process?

The Administrative Procedure Act (APA)[100/] exempts from its notice and comment requirements rulemakings which involve "a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts."[101/] While this exemption would clearly cover the SBA activities here under examination, the agency unequivocally waived its privilege in 1971.[102/] The waiver is now codified at 13 C.F.R. 101.9 (1982) and provides as follows:

> **§ 101.9 Public participation in rulemaking.**
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> SBA is governed as a matter of policy by the public participation provisions of the Administrative Procedure Act, 5 U.S.C. 553, notwithstanding the exemptions given by such section 553 for matters relating to agency management or personnel, or to public property, loans, grants, benefits, or contracts. Where, as provided by 5 U.S.C. 553, it is determined that such public participation procedures would be impracticable, unnecessary, or contrary to the public interest, a specific finding to this effect shall be published with the rules or regulations in question. Such exceptions from public participation procedures are not to be favored and will be used sparingly, as for example, in emergencies and in instances where public participation would be useless or wasteful because proposed regulations, or amendments thereto, cover minor technical matters. In connection with any notice of proposed rulemaking, written material or suggestions submitted will be available for public inspection during regular business hours at the office indicated in such notice.

On December 8, 1977, SBA initiated a notice and comment rulemaking proceeding to implement its mandate with respect to the pollution control facilities loan guarantee program.[103/] Following 60 days of public comment SBA

100/ 5 U.S.C. 551 *et seq*. (1976).

101/ 5 U.S.C. 553(a)(2) (1976).

102/ 36 *F.R.* 16716-17 (1971).

103/ 42 F.R. 62012 (1977).

issued its final rules which reflected substantive modifications of its original proposal as a consequence of the comments and its experience with several pilot projects.[104] It declared it to be the policy of the agency to issue loan guarantees "notwithstanding that the pollution control facility is acquired by the use of proceeds from tax-exempt industrial revenue bonds,"[105] and established the substantive requirements that applicants must meet and the procedures for application.[106] The consistent and exclusive practice of SBA from the inception of the program until December 1981 was to guarantee only contracts which received proceeds from tax-exempt bond issues. In December 1981, OMB enjoined SBA from issuing such guarantees. SBA complied. At no time prior to the termination of this aspect of the program did SBA give public notice that it was considering a change in its stated policy nor has the agency to date initiated a rulemaking proceeding pursuant to the requirements of the APA to revoke its established policy.

As a consequence of OMB's directive that SBA cease issuing such guarantees after December 31, 1981, 120 applications for $129 million in guarantees were stalled and have never been issued.[107] No new applications have been considered. Old applicants have been given the choice of having their applications considered on a taxable financing basis. Some have accepted this alternative, others have withdrawn their applications. Most have not responded.[108] Testimony has been given that taxable financing is not a feasible alternative for most small businesses.[109] The SBA itself has indicated that because it now only has the option of offering guarantees for taxable financing, the program has come to a standstill because of the higher cost of money and fees under taxable financing to the small concerns which they cannot bear, and the lack of interest in such instruments in the money markets. Moreover, SBA has noted that the sudden termination has caused hardship to applicants caught in the freeze. Some were under severe time constraints imposed by regulatory authorities. Others, acting in reliance on past agency policy and practice, had incurred engineering and other preconstruction expenses. Finally, it is SBA's assessment that the change in the nature of program has caused it substantial detriment.[110]

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[104] 43 F.R. 33231-33 (1978), codified at 13 C.F.R. Part 111 (1982).

[105] 13 C.F.R. 111.2 (1982).

[106] See text, *supra* pp 3 .

[107] House SBA Hearings, Part II, p. 11.

[108] *Ibid*.

Based upon the foregoing circumstances, a substantial case may be made that SBA has violated its obligations under the APA and impinged upon the Fifth Amendment due process rights of applicants for guarantees.

It is very well established that an administrative agency's failure to follow its own duly promulgated rules is a violation of due process.[111] SBA would appear to have violated this principle in two respects: by its failure to follow its own rule that it would adhere to APA rulemaking requirements; and by failing to process pending applications and to receive and process new ones in accordance with the policy and procedures established by its own rules which have never been revoked. The manner in which the courts have dealt with these issues is illustrated by the following cases which, among some of their common factual and legal issues, involve agencies like SBA which waived their exempt status under 5 U.S.C. 553(a)(2).

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[109] House SBA Hearings, Part I, 31, 33-69, Part II, 15-34, 51-67.

[110] Letter of James C. Sanders, Administrator, SBA to David A. Stockman, Director, OMB, dated April 29, 1982.

[111] See, e.g., United States ex rel. Accardi v. Shaughnessy, 347 U.S. 347 (1954); Service v. Dulles, 354 U.S. 763 (1959); Vitarelli v. Seaton, 359 U.S. 535 (1959); United States v. Nixon, 418 U.S. 687 (1974); Berends v. Butz, 357 F. Supp. 143 (D. Minn. 1973); Nader v. Bork, 366 F. Supp. 104 (D.D.C. 1973). See also Gardner v. FCC, 530 F.2d 1086 (D.C. Cir. 1976) (FCC action invalidated for its failure to adhere to long established procedures even though they had not been formalized in regulations.)

In Berends v. Butz[112] the Secretary of Agriculture had declared several counties in Minnesota disaster areas and in accordance with applicable statutes, affected farmers were entitled to apply for emergency relief loans. Interested farmers were informed that applications would be accepted and processed through June 30, 1973, that farmers should not apply until after their harvest was in so as to account for all losses, and that an abundant supply of funds was available in the program. For these and administrative reasons farmers were encouraged not to file applications until after January 1973. On December 27, 1972, without prior notice, the Secretary ordered the cessation of acceptance of emergency loan applications. The court held that the Secretary's action violated applicable statutes, agency regulations and due process of law. The court reasoned that the regulations involved gave the Secretary discretion whether or not to designate an area eligible for emergency relief, but that once he had exercised this discretion he had a duty to process those applications until the designations were duly revoked. "The language in the regulations is mandatory and the Secretary is directed to consider applications for emergency loans in designated areas. The refusal to consider applications for emergency loans in designated areas is a violation of the

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[112] 357 F. Supp. 143 (D. Minn. 1973).

Department's regulations."[113] The unilateral termination without notice was also held to "offend [] all traditional notions of fair play."[114] The court further held that the unilateral termination without notice violated the agency's regulation voluntarily subjecting itself to APA rulemaking procedures which, in turn, meant it had violated the applicable procedures of the APA that it had ignored.[115]

In Arlington Oil Mills, Inc. v. Knebel,[115a] the Court of Appeals for the Fifth Circuit held that a July 6, 1976 press release by the Department of Agriculture amending a March 19, 1976 determination concerning peanut price support levels was void for failing to comply with APA rulemaking procedures. The same waiver involved in Berends v. Butz was still in effect and the price support levels previously had consistently been set through notice and comment proceedings, including the March 19 determination. The July 6 revocation was without any prior notice or public proceedings. The Department argued that its July 19 announcement was simply a reconsideration of its March 19 announcement and thus those interested had already had adequate notice prior to the March 19 announcement. In rejecting this contention, the court stated:

> When the Department issued its March 19 press release concerning peanut differentials for the 1976 crop year, it had made a determination which was "final and conclusive" under 7 U.S.C. § 1429. Any further consideration by the Department of whether to alter this final decision fell within the APA's definition of rulemaking an "agency process for formulating, amending, or repealing a rule," 5 U.S.C. § 551(5), and the rulemaking procedures of the APA fully applied to the Department's determination of its July 6 announcement.

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[113] 357 F. Supp. at 152.

[114] Ibid.

[115] 357 F. Supp. at 153-54. The waiver is essentially the same as that made by SBA.

[115a] 543 F.2d 1092 (5th Cir. 1976).

> U.S.C. § 553. Accordingly, the duties imposed upon the Department under the APA in relation to the July 6 announcement were not complied with merely because the Secretary had fulfilled his APA obligations in relation to the March 19 announcement. The district court correctly concluded that the Secretary was required to provide adequate notice that reconsideration was underway and to give all interested persons a reasonable opportunity to participate and present their views before he arrived at the July 6 announcement. 5 U.S.C. § 553(b), (c). 115b/

The court also rejected a contention that since the March 19 rulemaking was defective in that it had not been published in the Federal Register, it should not be obligated to rescind in conformity with APA requirements. The court's answer was that where the original rule was promulgated in substantial conformity with the APA, its repeal must be effected in the same manner:

> The defendant-intervenors argue that the district court's treatment of the Department's two announcements is inconsistent and that either both must stand or both must fall as all parties had actual notice and an opportunity to participate in the rulemaking process in both instances. This argument has merit only if the procedures utilized by the Department in reaching its decision to make the reconsidered announcement were substantially similar to those involved in reaching its initial decision. It would be meaningless to require notice and a reasonable opportunity to participate in rulemaking, if after announcement of a rule, the agency could closet its intent to reconsider and completely undo the rule first made.
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> Our recitation of the events preceding the Department's two announcements, however, clearly demonstrates that we are not confronted with choosing between Tweedledee and Tweedledum. The simple answer to the defendant-intervenors' argument is that the March 19 announcement was determined in conformity with the APA with all interested parties having adequate notice and a full, fair opportunity to submit information and assert their views while the July 6 announcement was not. 116/

115b/ 543 F. 2d at 1099.

116/ 543 F. 2d at 1100.

The essentiality of conforming to APA requirements when revoking a rule as well as during the promulgation process was underlined in Consumer Energy Council of America v. FERC.[117] There, FERC had promulgated a rule pursuant to informal rulemaking procedures which was subjected to subsequent legislative review and veto by the Congress. After the veto, CECA petitioned FERC for a rehearing on the rulemaking to eliminate a provision in it conditioning its effectiveness on its survival of the congressional review process. FERC, however, instead revoked the rule to prevent it from taking effect should the veto be declared unconstitutional, and before the appeals court argued that the revocation was valid since it was issued as a result of a petition for reconsideration of the original rule and thus was effectively a continuation of the original proceeding which was properly conducted. The court disagreed, holding that such reasoning would defeat the rationale underlying notice and comment rulemaking:

> Sections 553(b) and (c) set forth notice and comment requirements for "rule making,"[72] which is defined in section 551(5) to mean "agency process for formulating, amending, or *repealing* a rule."[73] Thus, the APA expressly contemplates that notice and an opportunity to comment will be provided prior to agency decisions to repeal a rule. If the notice and comment provided prior to a rule's promulgation were meant to be sufficient to encompass any later repeal of the rule, simply because there was always a possibility that no rule would be adopted, the statute never would have included repeal of a rule within the definition of rulemaking.[74]

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[117] 673 F.2d 425 (D.C. Cir. 1982).

> The value of notice and comment prior to repeal of a final rule is that it ensures that an agency will not undo all that it accomplished through its rulemaking without giving all parties an opportunity to comment on the wisdom of repeal. Such an opportunity was lacking here. The Commission consistently stated that it had no choice but to issue a broad Phase II rule.[75] The Commission issued a final rule, and petitioners sought to amend the provision making the rule's effectiveness contingent on legislative review. Although the petition for rehearing said nothing about repealing the rule, and no other party requested such action, the Commission went ahead and rescinded it. The specific concerns that motivated this decision—the constitutionality of the legislative veto and the results that might follow from a judicial decision to strike down the veto—were different from those raised during the original rulemaking. All of these factors demonstrate that notice and comment would have been useful prior to repeal, and thus buttress further our conclusion that the Commission was required to follow section 553.[76]

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Finally, a recent ruling of the Court of Appeals for the Third Circuit in National Resources Defense Council, Inc. v. EPA 119/ appears pertinent here. In that case EPA postponed indefinitely the effective date of final amendments to certain regulations dealing with the discharge of toxic pollutants into publicly owned treatment works. It was argued that the indefinite postponement was not a rule and therefore was not subject to the APA. The court concluded that a indefinite postponement was a covered rule for if it were not subject to the APA it would cloak surreptitious repeals.

118/ 673 F.2d at 446. (footnotes omitted).

119/ 683 F.2d 752 (3rd Cir. 1982).

> If the effective date were not "part of an agency statement" such that material alterations in that date would be subject to the rulemaking provisions of the APA, it would mean that an agency could guide a future rule through the rulemaking process, promulgate a final rule, and then effectively repeal it, simply by indefinitely postponing its operative date. The APA specifically provides that the repeal of a rule is rulemaking subject to rulemaking procedures. 5 U.S.C. § 551(5). Thus, a holding that EPA's action here was not a rule subject to the rulemaking procedure of the APA would create a contradiction in the statute where there need be no contradiction: the statute would provide that the repeal of a rule requires a rulemaking proceeding, but the agency could (albeit indirectly) repeal a rule simply by eliminating (or indefinitely postponing) its effective date, thereby accomplishing without rulemaking something for which the statute requires a rulemaking proceeding. By treating the indefinite postponement of the effective date as a rule for APA purposes, it is possible to avoid such an anomalous result.[120/]

A fortiori, SBA could not assert that the suspension involved here is some sort of postponement and not final action that would require a public rulemaking proceeding.

It might be argued by SBA that although it has waived its exemption under 5 U.S.C. 553(a)(2), it has not waived the exception it would have for "interpretative rules and general statements of policy"[121/] which would allow it to bypass the public notice and comment requirements applicable to agency regulations. It would then further argue that 13 C.F.R. Part 111 is either an interpretative rule which is meant "to advise the public of the agency's construction of the statute which it is administering" or a general statement of policy which it has issued "to advise the public prospectively of

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[120/] 683 F.2d 762. See also, Council of Southern Mountains v. Donovan, 653 F.2d 573 (D.C. Cir. 1981).

[121/] 5 U.S.C. 553(b)(A) (1976).

the manner in which the agency proposes to exercise its discretionary power,"[122] thereby obviating the necessity for compliance with the informal rulemaking requirements of the APA.

The courts have consistently held that rules, whatever they are labelled by an agency, are substantive or legislative and subject to APA procedure if they have the effect of creating or altering substantive obligations or rights of persons outside the agency.[123] Under the instant circumstances it would appear difficult for SBA to sustain a position of non-applicability under the impact test. By its own assessment applicants have relied to their detriment on the agency's longstanding policy and practice.[124] Moreover, the rules themselves detail substantive requirements for eligibility which, until December 1981, if met would have assured an applicant of a guarantee.

But irrespective of the nature of the rule involved, the cessation of the pollution control equipment loan guarantee program for taxexempt issuances is the type of abrupt change of policy which the courts of late have subjected to intense judicial scrutiny. In one case, involving the rescission of a rule, the court held that "sudden and profound alterations in an agency's policy constitute 'danger signals' that the will of Congress is being ignored."[125] In such circumstances, a lengthy line of judicial precedent requires that

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[123] See, e.g., *Lewis-Mota* v. *Secretary of Labor*, 469 F.2d 478, 482 (2d Cir. 1972); *Texaco, Inc.* v. *FPC*, 412 F.2d 740, 744 (3rd Cir. 1969); *Pharmaceutical Manufacturers' Ass'n* v. *Finch*, 307 F. Supp. 858, 864 (D. Del. 1970) *National Motor Freight Traffic Ass'n* v. *United States*, 268 F. Supp. 90, 95-6 (D.D.C. 1967), aff'd 393 U.S. 18 (1968).

[124] See, *supra* note 110 and accompanying text.

[125] *State Farm Mutual Automobile Ins. Co.* v. *Dept. of Transportation*, 680 F.2d 206, 221 (D.C. Cir. 1982), *cert. granted*, 103 S. Ct. 340 (1982). See also, *Natural Resources Defense Council, Inc.* v. *EPA*, 683 F.2d 752, 760 (3rd Cir. 1982); *Building & Construction Trades Dept., AFL-CIO*, v. *Donovan*, 543 F. Supp. 1282, 1289-90 (D.D.C. 1982); *Center for Science in the Public Interest* v. *Department of the Treasury*, Civil Action No. 82-610, D.D.C. Feb. 8, 1983 (Pratt, J.), Slip Op. at 10-11.

"an agency changing course must supply a reasoned analysis"[126] of the factors justifying the change. In this regard the Supreme Court pointed out in *Atchison, Topeka & Santa Fe Railway Co*. v. *Wichita Board of Trade*, that a "settled course of behavior embodies the agency's informed judgment that, by pursuing that course, it will carry out the policies committed to it by Congress. *There is, then, at least a presumption that those policies will be carried out best if the settled* rule is adhered to."[127] Further, where an agency rescinds a regulation which was at one time presumed to be in furtherance of an agency's mandate, it has been held that it should make a showing that past rationale underlying and supporting the regulation is not being "casually ignored."[128] It also has been held that where an agency has sharply changed its substantive policy, "it makes sense to scrutinize the procedures employed by the agency all the more closely where the agency has acted, within a compressed time frame, to reverse itself by the procedure under challenge."[129] Underlying these holdings is the realization that only by holding up the reasons for agency decisionmaking to public scrutiny can the public be assured that the agency is acting rationally and can the courts effectively perform their task of review under the APA. In the words of the Court of Appeals for the District of Columbia:

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[126] *Greater Boston Television Corp*. v. *FCC*, 444 F.2d 841, 852 (D.C. Cir. 1971).

[127] 412 U.S. 800, 807-8 (1973) (emphasis added).

[128] *Greater Boston Television Corp*. v. *FCC*, *supra* note 126, 444 F.2d at 852.

[129] *Natural Resources Defense Council, Inc*. v. *EPA*, 683 F.2d 752, 760 (3rd Cir. 1982).

> Even absent special circumstances, it is vital that an agency justify a departure from its prior determinations. First, the requirement of reasons imposes a measure of discipline on the agency, discouraging arbitrary or capricious action by demanding a rational and considered discussion of the need for a new agency standard. The process of providing a rationale that can withstand public and judicial scrutiny compels the agency to take rule changes seriously. The agency will be less likely to make changes that are not supported by the relevant law and facts.
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Finally, apart from the potential irregularities stemming from SBA's failure to adhere to the APA's statutory requirements, a further problem of constitutional dimensions may be raised. While procedural due process has never been a term of fixed or invariable content, at its core it dictates that before a person may be deprived of life, liberty, or property by governmental action, he must be given notice of this fact (that is, he must be given notice of the proceedings that may affect him), he must be given an opportunity to defend himself against the deprivation, and the problem of the propriety of the deprivation, under the particular circumstances presented, must be resolved in a manner consistent with essential

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130/ Baltimore & Annapolis Railroad Co. v. Washington Area Transit Commission, 642 F.2d 1365, 1370 (D.C. Cir. 1980). See also, NAACP v. FCC, 682 F.2d 993, 998 (D.C. Cir. 1982) ("... where policy has been altered, the court should be satisfied both that the agency was aware it was changing its views and has articulated permissible reasons for that change, and also that the new position is consistent with the law."); Food Marketing Institutes v. ICC, 587 F.2d 1285 (D.C. Cir. 1978 (" . . . [I]t is a least incumbent upon the agency carefully to spell out the basis of its decision when departing from prior norms."); Columbia Broadcasting System v. FCC, 454 F.2d 1018 (D.C. Cir. 1971).

fairness.[131/] Under the circumstances heretofor detailed, a plausible constitutional challenge based upon the lack of notice to, and the consequent impact upon, affected members of the public might be successfully advanced.

In sum, then, SBA has offered neither notice of nor public explanation for its sudden change in policy. In view of the prevailing case law, there is a strong likelihood that a court reviewing the instant circumstances would find the cessation of the program unlawful on statutory or constitutional grounds, or both.

III. CONCLUSION

SBA's termination of its pollution control equipment loan guarantee program with respect to tax-exempt issuances at the direction of OMB raises substantial questions of legal propriety. The termination was effected without public notice or comment in spite of the fact that the longstanding policy and procedure governing the operation of the program was established by the informal rulemaking procedures of the APA. No formal explanation of the agency's reasons for its action has been given. There is evidence that members of the public whose applications have not been processed as a consequence of the termination have suffered material hardship because of their reliance on the continued viability of the program. SBA also concedes that the change in the nature and direction of the program is contrary to the original intentions of the Congress and has caused substantial detriment to the efficacy of the program. It

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[131/] See, e.g., *Mullane* v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314-15 (1950) *Morgan* v. *U.S.* 704 U.S. 1 (1938); *Consolidated Edison Co.* v. *NLRB*, 305 U.S. 197 (1938).

has stated that but for OMB's directive it would have continued to administer the program in the manner it had been historically committed. There appears to be no firm legal basis for OMB's authority to order the termination of the program. From this we conclude that it would not be unlikely for a court to find SBA's termination of the program to be unlawful for its failure to effect that action in accordance with the requirements of the Administrative Procedure Act and in violation of the Fifth Amendment for its failure to afford adequate notice of the agency's action to members of the public who were meant to be benefited by the program and who had justifiably relied on its continuation to their material detriment.

Morton Rosenberg

Morton Rosenberg
Specialist in American Public Law

Senator Packwood. Congressman Eckart is here. We will take him next, then we will move on to our panels.

Thank you for coming.

STATEMENT OF HON. DENNIS E. ECKART, U.S. REPRESENTATIVE FROM THE STATE OF OHIO

Mr. Eckart. Good morning, Senator.

This is my first time, Mr. Chairman, testifying before the Senate. I am not sure if the rules are the same, but I would like to insert a more lengthy statement.

Senator Packwood. Your entire statement will be in the record.

Mr. Eckart. I thank you.

I am pleased to be here to express my support and the support of almost 100 House Members on behalf of the small business participating debenture legislation which I have introduced as a companion bill to Senator Weicker's legislation, S. 842.

One frequent saying, Mr. Chairman, in the lexicon of smaller enterprises is that the difficult problems faced by the big businesses are twice as hard for small businesses to overcome. Yet, this is particularly true of capital formation.

I will not duplicate Senator Weicker's testimony, which fairly thoroughly explains the small business participating debenture legislation.

While the bill may be difficult to pronounce, the concept it embodies is fairly easy to understand. It is a new financing device that would enable both borrowers and lenders to profit from its use. The participating debenture is actually a new form of a hybrid security, a cross between a stock and a bond. The mechanism would help small businesses raise capital without sacrificing their ownership in their industry. It would increase the strength of the entrepreneur and I believe would be an extra tool that would be very helpful in helping small businesses deal with the consequences of high interest rates.

The SBPD would carry a nominal rate of interest and would pay a percentage of profits to the investor. For the borrower, all payments would be tax deductible; and for the lender, regular income taxes would be paid on the interest, and the lower capital gains tax would be paid on the profits made.

While we are now witnessing a rather anemic economic recovery, in my opinion true economic growth will not begin on Wall Street, but on Main Street and among our small businesses. By offering incentives for investment in small business, we can perpetuate the growing cycle of entrepreneurship that is so important to our economy.

Most of the growth we have experienced in the last decade has come from our smaller businesses throughout the United States. This sector needs help. It has been most adversely affected by the difficult economic circumstances of the last 2 years, and I believe that the SBPD would be an important tool in making more capital available to the real entrepreneurs, the real builders of our society.

This is an innovative and much needed tool to spur small business growth and development. This concept, Mr. Chairman, is broad-based and does have bipartisan support. It was recommended by the White House Conference on Small Businesses in 1980; has been endorsed by small business organizations in 33 States; and additionally, as I mentioned, almost 100 Members of the House have now joined me in cosponsoring this legislation, from both sides of the political aisle, covering all ranges of the political spectrum.

There is strong support for and a growing momentum behind this legislative proposal. I would encourage this committee, as it looks at dealing with the problems of economic recovery, to pay special attention to the needs of the small business person.

This is not the panacea. This is not a single cure. But Mr. Chairman, I believe it would be one more effective tool to help the small business person cope with the consequences of a difficult economic situation.

I thank the Chair for his courtesy.

[The prepared statement of Hon. Dennis E. Eckart follows:]

HONORABLE DENNIS E. ECKART

TESTIMONY BEFORE THE SENATE FINANCE TAXATION SUBCOMMITTEE REGARDING S. 842, SMALL BUSINESS PARTICIPATING DEBENTURES

OCTOBER 28, 1983

GOOD MORNING SENATOR PACKWOOD AND DISTINGUISHED MEMBERS OF THE COMMITTEE. I AM PLEASED TO BE HERE TODAY TO TESTIFY ON BEHALF OF S. 842, WHICH WOULD PROVIDE TAX INCENTIVES FOR THE ISSUANCE OF SMALL BUSINESS PARTICIPATING DEBENTURES. I HAVE A PARTICULAR INTEREST IN THIS PROPOSAL BECAUSE I HAVE INTRODUCED COMPANION LEGISLATION IN THE HOUSE.

ONE FREQUENT SAYING IN THE LEXICON OF SMALLER ENTREPRENEURS IS THAT DIFFICULT PROBLEMS FACED BY BIG BUSINESS ARE TWICE AS HARD FOR SMALL BUSINESS TO OVERCOME. THIS IS ESPECIALLY TRUE OF CAPITAL FORMATION. YET FOR SMALL BUSINESS TO PROSPER AND FLOURISH, IT IS ABSOLUTELY IMPERATIVE THAT AFFORDABLE CAPITAL BE MADE AVAILABLE. UNFORTUNATELY, THAT OPPORTUNITY DOES NOT EXIST IN TODAY'S ECONOMIC ENVIRONMENT.

AT ONE TIME, THE MOST IMPORTANT SOURCE OF CAPITAL FOR SMALL BUSINESS WAS THE COMMERCIAL BANK. GRADUALLY, HOWEVER, THE INDEPENDENT, LOCALLY OWNED AND OPERATED BANK ON THE CORNER HAS BEEN VIRTUALLY REPLACED BY LARGE, IMPERSONAL, STRUCTURED BANKS THAT ARE FAR LESS LIKELY TO LEND MONEY TO SMALLER CONCERNS, ESPECIALLY THOSE JUST STARTING UP AND WITHOUT PROVEN RECORDS. ANOTHER FACTOR INHIBITING CAPITAL FORMATION IS THAT A GROWING AMOUNT OF THE NATION'S WEALTH IS NOW FOCUSED ON INSTITUTIONS SUCH AS INSURANCE COMPANIES AND PENSION BENEFIT TRUSTS, WHICH ARE PREVENTED BY REGULATIONS AND LONG-STANDING TRADITIONS FROM INVESTING IN RISK SITUATIONS, EVEN IF THE RISK IS RELATIVELY LOW. AND WHILE A LIMITED NUMBER OF VENTURE CAPITALISTS WILL COMMIT CAPITAL TO JUST-FORMING BUSINESSES, THIS OPPORTUNITY IS USUALLY RESERVED FOR HIGH-RISK, HIGH-PROFIT VENTURES WITH A POTENTIAL FOR EXTRAORDINARY GROWTH. GENERALLY, THE FAMILY HARDWARE STORE THAT NEEDS CAPITAL FOR EXPANSION PURPOSES IS LEFT OUT IN THE COLD. IF ENTREPRENEURS DO MANAGE TO ATTRACT VENTURE CAPITAL FOR NEW COMPANIES, THEY FIND THAT THEIR FINANCIERS USUALLY SNAG A CONTROLLING INTEREST IN THEIR OPERATIONS IN EXCHANGE FOR THEIR CASH.

The bill offered by the distinguished Senator from Connecticut offers real help to small business concerns. It would enable entrepreneurs to borrow through the sale of a new hybrid security called the small business participating debenture, or SBPD.

While the SBPD is difficult to pronounce, the concept it embodies is easy to understand: It is a new financing device that would enable both borrowers and lenders to profit from its use. The participating debenture is actually a "hybrid" security -- a cross between a stock and a bond. The mechanism would help small businesses raise capital without sacrificing the key quality and strength of the entrepreneur -- equity ownership in his or her business. An SBPD would carry a nominal rate of interest and would pay a percentage of profits to the investor. For the borrower, all payments would be tax deductible; for the lender, regular income taxes would be paid on the interest and the lower capital gains tax would be paid on the profits payment.

The SBPD will provide a new, desperately needed source of capital for small businesses. It is likely to attract new investors because it offers an opportunity to share in the profits of a growing or potentially flourishing business. The participating debenture's limited downside risk would motivate banks and insurance companies to fully participate in the small business sector, a vital element of our economy. Product development, market development and physical expansion would all be furthered by enactment of the SBPD proposal.

WHILE WE ARE NOW WITNESSING AN ANEMIC RECOVERY, TRUE ECONOMIC GROWTH WILL BEGIN NOT ON WALL STREET, BUT ON MAIN STREET. BY OFFERING INCENTIVES FOR INVESTMENT IN SMALL BUSINESS, WE CAN PERPETUATE THE GROWING CYCLE OF ENTREPRENEURSHIP THAT IS SO IMPORTANT TO OUR ECONOMY. MOST OF THE GROWTH WE HAVE EXPERIENCED IN THE LAST DECADE HAS BEEN IN THE SMALL BUSINESS SECTOR AND STUDIES SHOW THAT EIGHT OUT OF TEN NEW JOBS ARE RELATED TO SMALL BUSINESS DEVELOPMENT. NEW CAPITAL INVESTMENTS AND JOBS GENERATED BY THE SBPD WOULD BRING IN FEDERAL REVENUE AND HELP TO FUEL ECONOMIC RECOVERY.

I BELIEVE THE TIME HAS COME FOR THIS INNOVATIVE AND MUCH-NEEDED TOOL TO SPUR SMALL BUSINESS GROWTH AND DEVELOPMENT. THE SBPD CONCEPT HAS BROAD-BASED, BIPARTISAN SUPPORT: IT WAS A RECOMMENDATION OF THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS IN 1980 AND HAS BEEN ENDORSED BY SMALL BUSINESS ORGANIZATIONS IN 33 STATES. ADDITIONALLY, 94 MEMBERS OF THE HOUSE, REPRESENTING BOTH SIDES OF THE AISLE, HAVE JOINED ME IN SPONSORING THIS IMPORTANT PROPOSAL. CLEARLY, THERE IS STRONG SUPPORT FOR AND A GROWING MOMENTUM BEHIND THE SBPD PROPOSAL.

I WOULD LIKE TO COMMEND THE CHAIRMAN OF THE COMMITTEE FOR HIS ATTENTION AND CONSIDERATION OF THIS ISSUE. I WOULD BE HAPPY TO ANSWER ANY QUESTIONS COMMITTEE MEMBERS MAY HAVE.

Senator **Packwood**. You will be happy to know that Senator Boren who is a member of this committee has just handed a statement to me in support of this bill. That is one more vote on this committee for it.

Mr. **Eckart**. Well, thank you.

Senator **Packwood**. Congressman, thank you for coming over. I am sorry we held you up a few moments.

Mr. **Eckart**. Well, that's OK. I appreciate the courtesies, and I appreciate you holding a hearing on this important bill.

Senator **Packwood**. It's good to have you with us.

Mr. **Eckart**. Thank you, Mr. Chairman.

Senator **Packwood**. Now, let's move on on S. 842 to a panel consisting of William Barth, Edward Pendergast, Robert Haddad, and Ron Cohen.

Gentlemen, as I have indicated to the Senators, to the Treasury, and to Congressman Eckart, your entire statements will be in the record. You know the time limits we are operating under, and I would appreciate it if you would abbreviate your statements.

Mr. Barth, go right ahead.

STATEMENT OF WILLIAM BARTH, DIRECTOR, SMALL BUSINESS LEGISLATIVE LIAISON, ARTHUR ANDERSEN & CO., CHICAGO, ILL., ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. **Barth**. Mr. Chairman, we are indeed grateful for this opportunity to speak on behalf of the proposal which has received the broadest support among small business persons and small business organizations.

My name is William Barth. I am director of Small Business Legislative Liaison of Arthur Anderson & Co., and I am also appearing today on behalf of the Small Business Legislative Council. This is an organization of 78 national trade associations, with 4.5 million members.

We have tried to organize, Mr. Chairman, our program this morning. I will give a very brief historical perspective, and then Mr. Haddad will speak on the need for and the availability of capital. Mr. Cohen will speak on who will invest and why will they invest, and finally Mr. Pendergast will make comments on the revenue estimate.

You have heard from two previous speakers of how an SBPD works, and therefore it should be unnecessary to go into that. But we will certainly be happy to work with you at any time to answer such questions as you or the staff members may have on this.

I would point out that there are no Federal guarantees under this program. There should be no need for new bureaucratic exercises brought about. This is an initiative of the private sector.

I first direct your attention to the breadth of support which has been given to the SBPD in the past. As you have heard, it was first identified as a high-priority recommendation of the White House Conference. The concept has since received the highest ranking recommendation of the first SEC Government Business Forum on Capital Formation. It has received the recommendation of the Small Business Legislative Council, the National Small Business

Association; it has been identified as a priority recommendation of Small Business United, which is a group of regional, State, and metropolitan small business associations in 19 States; it has received the recommendation of the American Institute of Certified Public Accountants, the Homestead Conference which was sponsored by the Small Business Committee of the American Bar Association; it has received the recommendation of the National Advisory Council of the Small Business Administration, and of the Senate Small Business Committee advisory council; and it has received a statement of endorsement and support from the then-candidate Mr. Reagan, issued in September 1980, just 2 months prior to his election to the Presidency.

You may question whether the SBPD can do for small business what it is intended to do. Well, the experience of a small bank in suburban Milwaukee indicates that it will do what it is intended to do; for this bank, after hearing of the concept at the White House Conference, began making participation loans with its customers back in 1980. It has today had outstanding somewhat less, slightly less, than a dozen loans. It is reported to me by the president of the bank that the customers like the loans, because there is a sharing of rewards and also a sharing of lesser returns.

I see that my time is up, and I will go ahead to Mr. Haddad.

[Mr. Barth's prepared statement follows:]

STATEMENT OF WILLIAM D. BARTH
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
FRIDAY, OCTOBER 28, 1983
ON S. 842, THE SMALL BUSINESS PARTICIPATING DEBENTURE

Mr. Chairman and Members of the Subcommittee, we very much appreciate the opportunity to appear before this important Subcommittee -- and after the high ranking Congressional panel which has just testified -- in this first Congressional hearing on Small Business Participating Debenture legislation.

We deeply appreciate the efforts of the chairmen of the full Committee (Senator Dole) and the Subcommittee (Senator Packwood) who have made it possible to come in and establish an official record on this measure.

My name is William Barth, and I am the Director of Small Business Legislative Liaison for Arthur Andersen & Co., where I have been in small business practice for the past 35 years. On this occasion, I am also representing the Small Business Legislative Council, an organization of 78 national trade associations speaking for 4.5 million small businesses. The member organizations of SBLC are listed in Exhibit 1, attached to my statement, followed by the text of the SBLC resolution in support of the Small Business Participating Debenture (Exhibit 2).

OUTLINE OF TESTIMONY

An outline of my testimony may be found in the one page summary accompanying this statement.

NEED FOR SMALL BUSINESS CAPITAL

As the Members of this Subcommittee know, measuring the lack of capital availability at various stages of the development of enterprises is extremely difficult. It was this realization that led the Senate Small Business Committee to propose, and the Congress to adopt, the Small Business Omnibus Capital Formation Act of 1980. That Act provided that the Securities and Exchange Commission, together with the Small Business Administration, perform the necessary economic research and discuss their findings in annual conferences. The statute further provides that these conferences are to be planned and attended by both the Federal agencies and the private sector small business and investment organizations having a vital stake in the capital formation process in this country. The first two Business-Government Forums on Small Business Capital Formation have taken place. The results, we believe, have justified this Congressional approach.

The Forum has demonstrated that small business capital needs change from Congress to Congress and from year to year. Small business difficulties with the corporate income tax, estate tax, depreciation and capital gains rates of the 1970's have been alleviated to a considerable extent by Congressional initiatives.

At the top of the list of recommendations of the first Forum in September 1982 was the Small Business Participating Debenture (see Exhibit 14).

Intuitively, all of us know that unglamourous, slower growth or low-tech small businesses have more problems raising capital than do glamourous, high-growth and high-tech enterprises. These obstacles, particulary pronounced in the realm of longer-term capital, have been documented by a study published by the present Administration, performed by Council for Northeast Economic Action in conjunction with five prominent banks across the country.

On the basis of extensive field research, the study's "conservative estimate" is that as many as 70,000 financially sound small independent firms, particularly those in rural areas, experienced significant unmet needs for intermediate and long-term financing.

Although the survey, which was concluded two years ago, in 1981, concluded that short-term credits are "relatively easy to secure," the finding was that "capital gaps are a reality" and in the realm of long-term financing, "roughly one out of four firms attempting to secure these credits is unsuccessful." ("Empirical Analysis of Unmet Demand in Domestic Capital Markets in Five U.S. Regions," Economic Development Administration, U.S. Department of Commerce, February 19, 1981, pages 4-5).

The key concepts here are longer-term and "bridge" financing. Longer-term usually means three, five or seven years. "Bridge" financing is one term for funding of small business development after the initial equity from the entrepreneur, friends and relatives has been fully deployed, and before a private placement or a public offering of securities is possible. At this juncture, the firm has established some kind of a track record in the market. Often the success of such a business prompts it to plan an expansion, perhaps to another location, another city, or another product line. Suppose the concern has been making water softeners for 25 years. Management now visualizes that, because of the current concern for pollution, there is a promising market for water purification units. Assume further that the firm wants to raise a relatively small amount of capital -- $500,000 or a million dollars to develop this new line of products.

Automatically, such a business is excluded from issuing bonds or commercial paper. These securities normally have a minimum threshold of $25 million in order to make the economics of such an issue worthwhile for the underwriter.

The normal recourse of such a business would be to bank credit. You may have become aware of the testimony of the National Small Business Association before the House Banking Committee on October 6th, which documents the differential in interest rates over the past year between larger and smaller bank loans. In brief, it shows that the larger loans (those of $1 million) have been made at about 1.67% below the stated prime rate, while the smallest loans have carried interest rates about 3% above the prime. Thus, the smaller businesses could be facing differentials of up to five percentage points in borrowing capital, a considerable competitive disadvantage.

Since we have entered an era of unprecedentedly high and floating interest rates, fixed rate borrowing is becoming increasingly a thing of the past, and the cost of debt capital generally borders on the prohibitive. (See Statement of the National Federation of Independent Business, "Bank Deregulation and Its Impact on Small Business Financing," House Small Business Subcommittee on Taxes and Equity Capital, October 19, 1983.)

Moreover, the era of rapid deregulation and restructuring of the financial service industry holds imponderable risks for the financing the nation's small business community. A recently concluded study by the Bank Administration Institute and Arthur Andersen & Co. concluded that between now and 1990, the number of banks in the country would decline by about a third and that the smaller community banks, which have been the mainstay of small business financing, would decline by a dramatic 41 percent. ("New Dimensions in Banking: Managing the Strategic Position," Arthur Andersen & Co., Bank Administration Institute, 1983, pages 2 through 8).

The American Institute of Certified Public Accountants has testified to the Senate Small Business Committee this year about the disruption in local capital markets and downgrading of personal and community considerations which its members have observed as a result of these trends. (Statement of AICPA, "Small Business Issues and Priorities, 1983," February 25, 1983, pages 573-83).

As a business moves up the economic scale, it could consider venture capital as a source of funds. If it does, it faces the prospect of giving up 20 to 50% of the company in return.

At the stage where an enterprise could consider a public securities offering ($500,000 in profits for a regional offering and about $1 million for a national offering), it must recognize that more and more of the independent securities houses, which have traditionally been the gateway to the public market for smaller firms, are being merged out of business. The National Association of Securities Dealers has concluded:

> "(This shrinkage) may suggest even more difficult times ahead for local developing companies seeking equity financing." (The Financial Services Industry of Tomorrow, NASD, November 1982, page 45).

So, small firms are being squeezed both from the debt side and the equity side. In such a climate, it is urgent that a new source of stable long-term bridge financing be developed.

HISTORY OF THE SBPD PROPOSAL

The SBPD is the leading candidate to resolve this double-barrelled problem. The participating debenture concept was first proposed at a May 15, 1978 public hearing of the Senate

Small Business Committee, conducted at the American Stock Exchange by the present Chairman of that Committee, the Senator from Connecticut (Mr. Weicker) and the former Senator from Maine (Mr. Hathaway). A panel of witnesses was assembled by the distinguished Chairman of the American Stock Exchange, Arthur Levitt, and we were privileged to take part in that panel.

It was our suggestion that the Small Business Participating Debenture would open up a source of financing for small business by restructuring the incentives to potential investors in those businesses. The basic concept was and is that investors might accept a lower fixed rate of interest, and in return, the business would be willing to grant those investors a share of future profits. As a result, the ultimate return to investors could be would be higher than the usual loan. Both the rate of interest and the share of profits would be negotiable by the private parties under marketplace conditions, and government regulation or paperwork would not be present.

The term "participating" stands for the share of profits which would be negotiated between the business and the prospective investor, and the term "debenture" denotes the underlying instrument which would be an unsecured note that would pay a stated rate of interest, would return the principal on a date certain, and would give the investor some preferences in the ultimate case where liquidation became necessary.

In 1979, the Senator from Connecticut (Mr. Weicker) developed this concept into a bill, which was introduced in the

96th Congress. The chronology containing the various bill numbers in the Senate and House is attached as Exhibit 3.

We appreciate Senator Weicker's efforts in pioneering this legislation, and his continuing interest in advancing it through the Congress.

We wish also to recognize the efforts of Representative Eckart, whose House bill (H.R. 1136) now has approximately 95 co-sponsors and Rep. Marriott, whose alternative approach retaining a tax credit, has attracted about 30 co-sponsors.

HOW THE SBPD WOULD WORK

The SBPD works by offering an investor two streams of income: (1) conventional interest, and (2) a negotiated share of the profits for a limited period of time.

Because the outside investors can thus look forward to a share of profits, they would normally be willing to settle for a lower interest rate, This reduces the fixed-rate monthly or quarterly payments which the business would be required to make.

An apt commentary on this mechanism, by the Senator from Rhode Island (Senator Pell) informed the Senate that:

> "As persons familiar with the business world know very well, a high fixed rate of interest is dangerous to the health of smaller businesses, because payments must be made in bad times as well as good.

> "It is likely that such high fixed costs are a significant factor in the record number of bankruptcies occuring over the past (few) years because some excellently managed firms could not meet their monthly payments." ("Small Business Participating Debenture," Congressional Record, July 26, 1983, p. S. 10905-06).

The technical keystone of the proposal is that the investor incentive be enhanced by classifying the profit share of the SBPD's return as capital gain. This has two consequences. Because the overall rate of return is higher, the incentive to invest in small business can better compete with other investment vehicles. Also, because capital gain carries a lower rate of taxation, there is an incentive for investors to keep their front-end interest costs as low as possible. This would improve the prospect that the business will prosper, and the share of profits out of which investors' major reward is taken, will be maximized.

This structure is made to order to the capital-short small business. Another aspect to this financing is also staunchly supported by the small business community: retention of ownership and confidentiality of the business.

As the members of this Committee know, the financial community, and particularly venture capital, has had extensive experience with hybrid instruments. Existing financing mechanisms include bonds and debentures with attached options, warrants, or conversion privileges.

The difference between all of these existing investment media and the SBPD is that, under present law and practice, the equity interests gained by outside investors now are permanent. In contrast, under the SBPD, the "equity-type" position of the lender/investor is temporary and carries no rights to vote or share in the management of the enterprise.

As Senator Pell stated:

> "A trade-off for this low interest is that the business must relinquish part of its profits. However the profits-share paid to the lender/ investor would be for only a limited period of time and not forever. Thus the owners of the enterprise -- and the overwhelming majority of the 16 million ventures in the United States are closely held -- would not be required to part with any of their precious ownership equity."

This feature of the SBPD does much to explain its popularity with the small business community.

To illustrate the mechanics of this instrument, the following chart is based upon a company which has issued $100,000 worth of SBPD's or small notes allowing participation (SNAP). In the first example, it agreed to pay a hypothetical 6% interest and 15% of profits. The first year the company earns $100,000 of pre-tax profit and the return to the investors is as follows:

RATES OF RETURN
For Small Business Participating Debenture
at various interest and profit-share levels.

Example 1:	Interest 6% Profit-share 15%	After Tax Rate of Return		
		Pre-tax	Tax Rate	After Tax
Income of Business	$100,000			
SBPD/SNAP interest return	x .06			
Less interest	6,000	$ 6,000	50%	$ 3,000
Balance	94,000			
SBPD/SNAP 15% of profits	14,100	14,100	20%	11,280
Profits retained by business	$79,900	$20,100	Total	$14,280

This would represent a composite 14.3% return after taxes. If the interest rate were 10%, and the share of profits were 12%, the after-tax rate of return to a 50% bracket individual taxpayer would be 13.6%.

The further advantages to the investor are: (1) if a profit is earned, investors would receive the bulk of their return at the 20% capital gain rate; (2) this lightly taxed income is received currently, rather than deferred; and, (3) interest is also received at the negotiated rate.

Same assumptions: Business issues a $100,000 SBPD and earns pre-tax profits of $100,000 for the current year.

	Interest	Profit-Share	After tax Rate of Return
Example 2	11.5%	13.5%	15.31%
Example 3	10%	30%	26.60%

The second of these examples is based upon a composite of actual experience with a similar instrument in Wisconsin, to be discussed later in this statement; and the third is based upon what a typical deal with a Small Business Investment Company might be.

WIDE SPECTRUM OF SUPPORT

Since the introduction of this proposal, the SBPD has gained wide support both inside and outside of Congress. It is particularly encouraging that this support is in both Houses and both parties. Senator Weicker's bill which is before you this morning (S. 842, introduced March 17, 1983) has 17 sponsors, three of whom are on the Senate Finance Committee (Senators Heinz, Boren and Baucus).

In the House, we have mentioned that the bill introduced by Rep. Dennis Eckart of Cleveland (H.R. 1136) has 95 co-sponsors; and a similar measure introduced by Rep. Marriott (H.R. 1902) has about 30 co-sponsors. Since 1978, we have not seen a single member of Congress speak in opposition to this concept.

President Reagan while a candidate explicitly endorsed the SBPD as has the Democratic National Committee Small Business Council (Exhibit 7).

As you will recall, the SBPD was the fifth highest ranking recommendation of the White House Conference on Small Business in January, 1980. The Conference was probably the most widely representative small business assembly ever in the U.S., with delegates elected by 25,000 small business owners attending regional and local conferences throughout the nation during 1978 and 1979.

As we have seen, the SBPD was the highest ranking recommendation of the first SEC Government-Business Forum on Capital Formation in 1982. Other private organizations which have endorsed the SBPD/SNAP are the following:

- The Small Business Legislative Council consisting of 78 national trade association (Exhibit 2).
- The National Small Business Association (Exhibit 4).
- The Small Business National Advisory Council (Resolution Number 24 of September 16, 1982) (Exhibit 5).
- Small Business United, a coalition of regional, state and metropolitan small business associations in 19 states (Exhibit 6).
- The Democratic National Committee Small Business Council (Exhibit 7).
- The American Institute of Certified Public Accountants (Exhibit 8).
- The American Bar Association Homestead Conference (Exhibit 9).

It is also pertinent that the Reagan/Bush campaign in a September 25, 1980 letter to the National Small Business Association by Edwin J. Gray, transmitted President (then-candidate) Regan's endorsement of the small business participating debenture concept in the following specific terms:

"Capital Formation

I strongly suport initiatives to assist small business in locating and retaining capital.

I favor the creation of a Small Business Participating Debenture, to allow investors to participate in earnings growth, without requiring entrepreneurs to sell their interest in the business to acquire capital.

I strongly support accelerated, simplified depreciation procedures for business investment. I do not, however, favor a limitation on the amount of depreciation that a company could claim." (Exhibit 10).

EXPERIENCE WITH A SIMILAR INSTRUMENT

At least one institution has begun experimenting with an instrument which is as close to the SBPD format as the present law allows.

The Brown Deer Bank, located in a suburb of Milwaukee, has made nearly a dozen loans over the past few years based on the concept of participating in profits for a temporary period, but without the capital gain feature, of course.

The bank, protecting its downside, has set the interest rate at the stated New York prime rate. This, as we have seen, provides a differential above the rate provided to the best bank customers. Accordingly, even if there are no profits, out of which the bank can enhance its ultimate return, it still makes money on the transaction.

In Wisconsin, the average loan has been about $200,000, which incidentally is exactly half of the average loan apparently assumed by the Joint Tax Committee in 1980.

The percentage of profits negotiated by the Bank and the borrowers has ranged between 2 and 25%, reflective of the wide variety of situations in the market place.

Further, not one of these transactions has been a start-up, confirming the suitability of this vehicle for companies with an established track record.

Bank officials responsible for the administration of these loans observe that borrowers are somewhat surprised when the bank first suggests this arrangement, but that after understanding the elements of the transaction, have been enthusiastic.

Further, the bank is satisfied, because all of its loans so far have been profitable. Interest has been at a variable rate. Further reference can be made to Dean Treptow, president of the Brown Deer Bank for further detail in regard to these transactions, and we suggest it would be valuable to study this experience closely.

EFFORTS TO REFINE THE LEGISLATION

Since 1978, the proponents of this security have worked hard to cooperate with the Congressional sponsors of the legislation to refine its policy and technical elements.

At the beginning of this year, we were encouraged by a series discussions involing staff representatives of Senate and House sponsors on a bipartisan basis, and the principal private sector organizations interested in these bills. We sought the formulation of a uniform bill and refining such a proposal in order to minimumize revenue costs.

One of these meetings was on May 23, 1983, arranged by the staff of the Senate Small Business Committee. At that time, a detailed and very helpful technical critique of the bill was offered by Harry Graham, a counsel to the Finance Committee staff. A memorandum itemizing these suggested improvements will be appended as Exhibit 11.

Some of the suggestions were: prescribing foreign ownership (as does the Small Business Investment Company program), restricting the amount of passive income, personal holding company income or real estate as a condition of eligibility for such a loan. Other persons have recommended reevaluation the size limitations of the bill. None of these modifications would, in may opinion, impair the basic purpose of the SBPD which is to assist in raising capital for active trades and businesses and not for passive investment-type ventures. We continue to hope that the bill will be improved along such technical and policy lines, and that other observations of House and Senate sponsors and staffs will also be taken into account in improving the legislation.

REVENUE ESTIMATE ON IMPROVED LEGISLATION NEEDED

The most recent Treasury revenue estimate, of July 13, 1983, was rendered on the SBPD bill (S. 842) before any of the improvements just discussed had been made.

Further, these Treasury estimates stated no assumptions, gave no explanation and, therefore, did not provide a basis for analyzing which parts of the legislation might produce revenue losses and to what extent.

We would like to invite the Subcommittees attention to the Joint Tax Committee revenue estimate of September 2, 1980, attached as Exhibit 12. Based on a bill which proposed more liberal benefits than the present S. 842, it projected significantly lower revenue numbers than the Treasury estimates.

There was an opportunity to inquire about the thinking behind the 1980 estimates, and the memorandum accompanying Exhibit 12 reflects what we believe to be accurate assumptions used at thst time. It is noteworthy that paragraph 6, on page 4 of the memo, comments that if small business firms earn 10% on the capital generated by such debentures, the prospective revenue losses would be offset completely. The memo further observes that if the aggregate return on the borrowed funds reached 12%, "additional corporate taxes would be $3.3 billion for the 5th year of the program , roughly $500,000,000 more than the revenue loss estimated by the Joint Tax Committee."

One of the subsequent witnesses, Mr. Pendergast, of the Smaller Business Association of New England, has done sophisticated work on the revenue estimates for the SBPD, and we recommend to the Subcommittee his testimony, as well as that of the other respected members of this business panel: Mr. Robert Haddad of Boston and Mr. Ronald Cohen of Cleveland.

The possibility that the SBPD, properly framed, could make a positive contribution to the economy and to Federal revenues, argues strongly for a further exploration of this instrument. We would hope that following a further round of refinements, the bill will again be presented for a revenue estimate that will be explicit as to its assumptions and calculations, so we can learn which provisions account for how much revenue and why. This would enable the proponents of the legislation to attempt to cope with the problems perceived by the government's tax experts.

CONCLUSION

The wide support for the SBPD in the small business community and in the Congress is an indication of the potential value of this concept.

We pledge our best efforts to assist in whatever way we can in bringing this bill to a point where Congress can favorably consider and enact such a proposal. We believe that the benefits of the SBPD will go beyond the individual small businesses, which could not otherwise obtain long-term financing on acceptable terms. We believe SBPD will strengthen our general economy and competitive stature in the world, and will also, on balance, materially contribute to the revenues of the Federal Government.

We therefore hope Congress will press forward to perfect this legislation.

STATEMENT OF ROBERT HADDAD, PRICE WATERHOUSE & CO., BOSTON, MASS., ON BEHALF OF SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, BOSTON, MASS.

Mr. Haddad. Mr. Chairman, good morning. I am Bob Haddad from Price Waterhouse in Boston. I am here representing the Smaller Business Association of New England, SBANE, as the chairman of their tax committee and as a director.

My testimony as submitted in writing has a great amount of detail which will support my oral testimony, which I will try to keep as brief as possible.

I guess I would like to focus on two things this morning, from my perspective, having to do with capital. First, just some conclusions that I have drawn from the State of Small Business Report that was submitted to Congress by the President in March 1983. Three points were made:

"Small businesses play a disproportionate role in the vitality of our economy." That's a conclusion.

"Small business has experienced an increased risk of business failure, a risk which could be significantly reduced by providing them with increased access to capital, which is their major problem.

"Small businesses are experiencing severe difficulties obtaining capital from their traditional source of funds," that is, banks.

What are the current developments or the developments in the last couple of years that have affected small business access to capital?

First, in the tax related area there are four: The Economic Recovery Tax Act of 1981, whose major provision had to do with the accelerated cost recovery system, was a capital-intensive tax modification in the law, and unfortunately less than 25 percent of small businesses are capital intensive. So the impact on small business of that legislation was not significant in terms of the capital formation aspect.

Industrial development bonds have been diluted as the result of the 1982 Tax Act, and there is a bill currently before Congress that will further dilute access to and the availability of those funds.

The debt-equity regulation, section 385, is a subject of great concern to small business. It continues to be pursued by the Treasury in their attempts to disallow interest deductions on the debt that is owed by small businesses to various banks and other institutions.

The jobs credit, once thought to be a major potential source of capital for small business, because of targeting and because of the nonrefundable nature of the credit, has not enabled small business to generate capital from this source.

Access to bank debt in the nontax area? Bank merger activity and the elimination of approximately 36 percent of the small banks in this country over the next 8 years is going to severely limit the access to bank debt that small businesses have otherwise had available. Studies have demonstrated clearly that the access to bank debt for small business has been on the decline, not the increase.

Venture capital requires a substantial relinquishment of equity position in the company and is a very expensive source of capital for small business.

Other capital sources, in the form of institutional insurance, pension, and trust funds, are clearly not generally available as sources of capital for small business because of regulation and risk factors.

Accordingly, SBANE is asking for the encouragement of and legislation of the SBPD's in order to provide them with a source of capital that ought to be moderately priced and should provide them with an opportunity to sustain their growth in troubled economic times.

I will end, since the bell has rung.

Senator PACKWOOD. Thank you.

Mr. Cohen.

[Mr. Haddad's prepared statement follows:]

SBANE

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

SUMMARY OF TESTIMONY

I. Introduction - Good Morning

A. I am Robert L. Haddad, a Small Business Tax Partner with Price Waterhouse in Boston

B. I am representing the Smaller Business Association of New England (SBANE) of which I am Chairman of the Tax Committee.

II. Overview of Testimony

A. My oral testimony will address the following:

- The state of Small Businesses generally and in particular their need for capital.
- The available sources of capital for Small Businesses and the current state of these sources.
- Why SBANE supports the SBPD.
- Why the SBPD is, to this date, an idea as opposed to a reality.
- Problems inherent in the Joint Committee revenue study, which projected revenue losses due to the implementation of the SBPD.
- Conclusion

B. My submitted written testimony supporting SBANE's position in favor of SBPDs includes the following:

- A more detailed discussion of the benefits of the SBPD.
- A recent Wall Street Journal article in the October 13, 1983 issue, which emphesizes the difficulties Small Businesses continue to encounter in their quest for capital.
- A copy of the Joint Committee Revenue Study.
- SBANE Legislative Alert on IDBs.

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- A memorandum analyzing and elaborating on the Joint Committee Revenue Study.
- Excerpts from The State of Small Business: A Report of the President, Transmitted to the Congress, March, 1983.
- A report from the Small Business Advisory, October 17, 1983 which discusses a recent banking industry study.

III. The State of Small Business - from the March, 1983 President's Report to Congress

A. Facts

- Of the 13.3 million non-farm businesses in the United States approximately 98% are Small Businesses.
- Small Businesses account for almost half (47.9%) of the nation's employment.
- Small Businesses are the nation's primary source of new jobs.
- Small Businesses account for the majority of innovative business ideas.

B. Conclusions

- The conclusion to be drawn from these facts is self evident, Small Business plays a crucial and disproportionate role in the vitality of our country's economy.
- The strength of our nation's economy rests on the vitality of Small Business.

C. Additional Facts

- Due to inflation, severe debt burdens, high interest rates and the length of the recession, business bankruptcies increased 38% in 1982.
- One half of the bankruptcies in 1981 and 1982 affected businesses in existence less than 5 years. Nearly 75% of these bankrupt companies had fewer than 20 employees.
- 99% of all businesses filing for bankruptcy had fewer than 100 employees and 50% of these failing businesses had liabilities of less than $100,000.
- Banks, the major source of borrowed capital for Small Businesses, clearly favor big business. Over the past 3 years short term lending to big businesses increased 400% versus 25% for smaller businesses. Also, over the same period, there was no increase in long term lending for loans under $100,000.

D. Conclusions

- Small Businesses play a disproportionate role in the vitality of our economy.
- Small Businesses experience an increased risk of business failure, a risk which could be significantly reduced by providing small businesses with increased access to capital throughout their business life.
- Small Businesses are experiencing severe difficulties obtaining capital from their traditional source of funds, namely banks.

IV. Other Critical Developments that have Adversely Affected Small Businesses' Access to Capital.

A. Tax Related

- Economic Recovery Tax Act of 1981

  a. The major tax benefit of the Act, the Accelerated Cost Recovery System, is essentially limited to capital intensive companies. Less than 25% of Small Businesses are capital intensive.

  b. No significant benefits were provided for Small Businesses.

- Industrial Development Bonds were a major source of Small Business capital in our region for years. The benefits of IDB's were substantially diluted in 1982 and could be further diluted if current bills before Congress are enacted into law.

- Debt/Equity Regulations, Section 385 - The Internal Revenue Service is continuing its effort to treat debt as equity in order to disallow interest expense deductions. Application of Treasury Regulations under Section 385 creates an onerous burden on Small Businesses.

- Jobs Credit - Once thought to be a major capital generator in the service businesses, this has not been the case since the credit became targeted as well as nonrefundable. The targeting limits the benefits and the credit's nonrefundable nature causes it to benefit only companies in taxpaying positions. Many growing Small Businesses are not yet in taxpaying positions.

B. Access to Bank Debt

- As previously discussed debt financed capital from this source has not increased whereas loans to larger businesses have increased dramatically.
- According to a recent Wall Street Journal article, Small Businesses must borrow at anywhere from 3 to 5 percent higher than larger businesses.
- The impact of current bank merger activity on Small Businesses has to date not been evaluated, as we recently discovered at hearings on a major bank merger in Massachusetts. It is clear, however, that the reduction in small owner-managed banks will reduce the borrowing capabilities of Small Businesses. A recent study of commercial banking in the United States indicates that this situation will continue to deteriorate. The study conducted by Arthur Andersen & Co., and the Bank Administration Institute states that the number of small banks (assets less than $100 million) will decline by 5400, or by 36% by 1990.

C. Venture Capital

- The cost of this type of capital to the entrepreneur is generally 40% to 60% of the equity in the business. This is a significant cost of capital to the small businessperson.

D. Other Capital

- More and more of the nation's wealth is being accumulated by insurance companies, pension and profit sharing trusts and similar institutions. Regulations and traditional investment habits prevent these funds from being directed toward risk situations. In fact, even low risk situations involving Small Businesses, are generally not acceptable as investments in the institutional marketplace.

V. SBANE Position

A. Small Businesses cannot thrive without reasonably priced capital, a resource that is not currently available in adequate amounts. SBPDs represent a vehicle to supply this capital and we wholeheartedly support legislation that provides for their implementation.

B. Why?

- When all factors are considered, implementation of the SBPD will result in increased revenues, as opposed to losses, to the government.
- The concept has been discussed with and analyzed by a number of Senators and Congressmen who support the SBPD.
- The capital market clearly has the funds available and should be enticed by the favorable tax treatment of the SBPD.
- Additional equity capital should assist Small Businesses in obtaining lower cost and more accessible debt financing.

C. Query?

- How can it be that such a common sense, economically favorable proposal, with broad based support, has not been enacted into law?
  - The primary reason relates to a revenue study by the Joint Committee on Taxation that fails to reflect the true economic impact of the legislation.
  - The revenue study of the Joint Committee on Taxation and Issues concluded that the enactment of the SBPD would result in a 6.1 billion dollar loss over the initial five year period after enactment.
  - However, an analysis of the study points out that:

> These calculations do not reflect additional tax revenues that would be generated from expanded business from the small business sector financed through the Small Business Debenture proposal. If it is assumed that a small business entity can earn pre-tax profits of only 10% of the debentures issued, additional tax revenues would be generated at the corporate level sufficient to offset the revenue loss estimate determined by the Joint Committee.

If the business entity can earn 12% on funds received through the small business debenture route, additional corporate taxes would be $3.3 billion for the fifth fiscal year after enactment, or roughly $500 million more than the estimated revenue loss. If we also add the tax that would be imposed at the shareholder level when these earnings are distributed to the owners of the businesses, between $2.2 - 2.7 billion could be generated.

D. Is this a Loss - We Say No.

- o Obviously capital would not be borrowed or used if it were not needed for growth and/or survival.
- o As money is invested, jobs and tax dollars would be generated and since no tax benefits are achieved upon investment, it does not seem possible that a loss could be created.

E. Allow me to make reference to a recent capital investment bill which permitted an immediate tax deduction at the time of investment.

- o The proposal was analyzed by the Joint Committee to evaluate revenue impact.
- o It was concluded that the revenue loss would be negligible in the initial year.
- o See Exhibit A which compares this proposal with the SBPD proposal. It seems incredulous that similar investments with the completely different initial tax treatment noted, would result in revenue losses for SBPD and virtually no losses for the direct write-off proposal. Mr. Pendergast will provide further analysis of the revenue impact of the SBPD in his presentation.

VI. Conclusion

SBANE firmly believes that the sole reason for the failure of this vital legislation thus far is the misinterpretation/misevaluation of its revenue impact. Small Businesses are the backbone of our economy. Their continued and increased vitality is integral to the economic recovery our nation is beginning to experience. We believe that the SBPD will inject new life into smaller businesses across the country and consequently hasten our economic revitalization.

Thank You.

EXHIBIT A
COMPARISON OF REVENUE COST OF SBPD LEGISLATION VERSUS DIRECT WRITE-OFF OF INVESTMENT

	SMALL BUSINESS PARTICIPATING DEBENTURE	NEW VENTURE INVESTMENT INCENTIVE ACT
Initial Year		
Initial Investment	$30,000, 6% annual interest, 1% earnings payable end of year 5	$30,000, 6% interest and 1% earnings both payable upon redemption (year 5)
Initial Year Investor Deduction	None	$30,000
Revenue Impact - Gain/(Loss)	None	(15,000)
Annual Interest Payment	$1,800	None
Revenue Impact - Gain/(Loss)		
Borrower Deduction	(900)	None
Investor Interest Income	900	None
A. Net Revenue Gain/(Loss)	None	(15,000)
Payment on Disposition (Year 5)		
Principal	30,000	30,000
Revenue Impact Gain/(Loss)	0	15,000
Return on Investment	5,000	14,000*
Revenue Impact - Gain/(Loss)		
Borrower Deduction	(2,500)	0
Investor Inclusion at Capital Gain Rates - 20%	0	0
B. Net Revenue Gain/(Loss)	(2,500)	15,000
Time Value of Money		
Loss of Use of $15,000 for 5 years @ 10%	0	(7,500)
C. Net Revenue Gain/(Loss)	0	(7,500)
Total Revenue Gain/(Loss)(A+B+C)	$(2,500)	$(7,500)

Assumptions

1. 50% Tax Bracket
2. Borrower Earning $100,000 per year
3. Overall assumption is that pretax yield whether in the form of dividends or interest is the same under either instrument.

*$1,800/yr. x 5 yrs. = $9,000 plus 1% of earnings ($1,000/yr.) = $14,000

I. EXPLANATION OF SBPD

A. SBANE supports legislation creating the SBPD as a means of providing capital to small businesses without access to the equity capital markets

B. The SBPD would be a hybrid security, as a written debt instrument, issued by a qualifying small business, which:

1. Is a general obligation of the company
2. Bears a stated rate of interest not less than a standard imputed interest rate specified by the Secretary of the Treasury
3. Has a fixed maturity date
4. Grants no voting or conversion rights in the company
5. Provides for the payment of a share of the company's total earnings to the investor

C. The specific terms of the SBPD, such as the interest rate, maturity date and share of earnings, would be determined by the market for the security.

II. ADVANTAGES OF SBPD:

A. To Small Business Borrowers

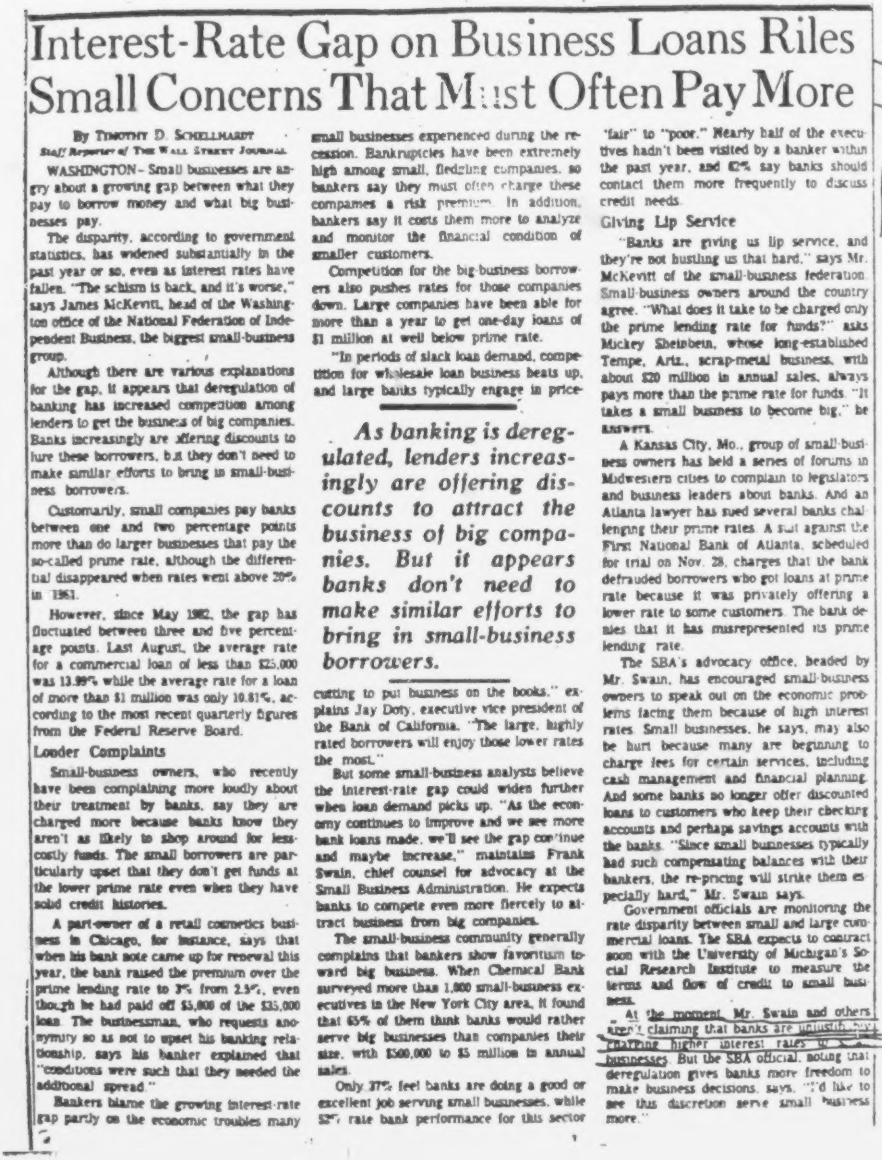
1. Interest payments would be a deductible expense.
2. Obtaining growth capital via SBPD's would not require giving up a share of the business to an outsider.
3. The SBPD is self-administering; no additional government red tape would be required.
4. Since return on investment (for the lender) depends on the business' profitability, the business would have a lender with a vested interest in the firm's success.
5. Both the cost of borrowing and the amount of borrowing could be reduced as a result of tax benefits provided to investors.

B. To SBPD Investors

1. The interest paid by the borrowing business would be taxed as ordinary income to the lender.
2. The share of the borrowing business' profits would be taxed at the preferential capital gains rate.
3. The lender would be entitled to deduct any losses incurred as ordinary losses.

C. To Government

1. Administration inexpensive since no government involvement required
2. No risk of loss to government



Interest-Rate Gap on Business Loans Riles Small Concerns That Must Often Pay More

10/13/83 WSJ

By TIMOTHY D. SCHELLHARDT
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – Small businesses are angry about a growing gap between what they pay to borrow money and what big businesses pay.

The disparity, according to government statistics, has widened substantially in the past year or so, even as interest rates have fallen. "The schism is back, and it's worse," says James McKevitt, head of the Washington office of the National Federation of Independent Business, the biggest small-business group.

Although there are various explanations for the gap, it appears that deregulation of banking has increased competition among lenders to get the business of big companies. Banks increasingly are offering discounts to lure these borrowers, but they don't need to make similar efforts to bring in small-business borrowers.

Customarily, small companies pay banks between one and two percentage points more than do larger businesses that pay the so-called prime rate, although the differential disappeared when rates went above 20% in 1981.

However, since May 1982, the gap has fluctuated between three and five percentage points. Last August, the average rate for a commercial loan of less than $25,000 was 13.99% while the average rate for a loan of more than $1 million was only 10.81%, according to the most recent quarterly figures from the Federal Reserve Board.

Louder Complaints

Small-business owners, who recently have been complaining more loudly about their treatment by banks, say they are charged more because banks know they aren't as likely to shop around for less-costly funds. The small borrowers are particularly upset that they don't get funds at the lower prime rate even when they have solid credit histories.

A part-owner of a retail cosmetics business in Chicago, for instance, says that when his bank note came up for renewal this year, the bank raised the premium over the prime lending rate to 3% from 2.5%, even though he had paid off $5,000 of the $35,000 loan. The businessman, who requests anonymity so as not to upset his banking relationship, says his banker explained that "conditions were such that they needed the additional spread."

Bankers blame the growing interest-rate gap partly on the economic troubles many small businesses experienced during the recession. Bankruptcies have been extremely high among small, fledgling companies, so bankers say they must often charge these companies a risk premium. In addition, bankers say it costs them more to analyze and monitor the financial condition of smaller customers.

Competition for the big-business borrowers also pushes rates for those companies down. Large companies have been able for more than a year to get one-day loans of $1 million at well below prime rate.

"In periods of slack loan demand, competition for wholesale loan business beats up, and large banks typically engage in price-cutting to put business on the books," explains Jay Doty, executive vice president of the Bank of California. "The large, highly rated borrowers will enjoy those lower rates the most."

As banking is deregulated, lenders increasingly are offering discounts to attract the business of big companies. But it appears banks don't need to make similar efforts to bring in small-business borrowers.

But some small-business analysts believe the interest-rate gap could widen further when loan demand picks up. "As the economy continues to improve and we see more bank loans made, we'll see the gap continue and maybe increase," maintains Frank Swain, chief counsel for advocacy at the Small Business Administration. He expects banks to compete even more fiercely to attract business from big companies.

The small-business community generally complains that bankers show favoritism toward big business. When Chemical Bank surveyed more than 1,000 small-business executives in the New York City area, it found that 65% of them think banks would rather serve big businesses than companies their size, with $500,000 to $5 million in annual sales.

Only 37% feel banks are doing a good or excellent job serving small businesses, while 52% rate bank performance for this sector "fair" to "poor." Nearly half of the executives hadn't been visited by a banker within the past year, and 62% say banks should contact them more frequently to discuss credit needs.

Giving Lip Service

"Banks are giving us lip service, and they're not hustling us that hard," says Mr. McKevitt of the small-business federation. Small-business owners around the country agree. "What does it take to be charged only the prime lending rate for funds?" asks Mickey Sheinbein, whose long-established Tempe, Ariz., scrap-metal business, with about $20 million in annual sales, always pays more than the prime rate for funds. "It takes a small business to become big," he answers.

A Kansas City, Mo., group of small-business owners has held a series of forums in Midwestern cities to complain to legislators and business leaders about banks. And an Atlanta lawyer has sued several banks challenging their prime rates. A suit against the First National Bank of Atlanta, scheduled for trial on Nov. 28, charges that the bank defrauded borrowers who got loans at prime rate because it was privately offering a lower rate to some customers. The bank denies that it has misrepresented its prime lending rate.

The SBA's advocacy office, headed by Mr. Swain, has encouraged small-business owners to speak out on the economic problems facing them because of high interest rates. Small businesses, he says, may also be hurt because many are beginning to charge fees for certain services, including cash management and financial planning. And some banks no longer offer discounted loans to customers who keep their checking accounts and perhaps savings accounts with the banks. "Since small businesses typically had such compensating balances with their bankers, the re-pricing will strike them especially hard," Mr. Swain says.

Government officials are monitoring the rate disparity between small and large commercial loans. The SBA expects to contract soon with the University of Michigan's Social Research Institute to measure the terms and flow of credit to small business.

At the moment, Mr. Swain and others aren't claiming that banks are unjustifiably charging higher interest rates to small businesses. But the SBA official, noting that deregulation gives banks more freedom to make business decisions, says, "I'd like to see this discretion serve small business more."

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SEP 2 1980

The Honorable Lowell Weicker, Jr.
United States Senate
Washington, D. C. 20510

Dear Senator Weicker:

This is in response to your request for a revenue estimate of legislation creating small business participating debentures (SBPD's). In accordance with a conversation with Mr. Stan Twardy of your staff, we are providing an estimate for S. 2981 rather than for S. 1481, which has, as an additional incentive, a credit against tax for investment in SBPD's.

Below is listed the estimated reduction in fiscal year receipts for S. 2981 assuming enactment in October, 1980.

1981	1982	1983	1984	1985
		($ billions)		
0.1	0.4	1.0	1.8	2.8

Sincerely,

Bernard M. Shapiro

SBANE
LEGISLATIVE Alert

SEPTEMBER 1983

TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS THREATENED

CAUSE FOR ALARM: The House Ways and Means Committee is scheduled to act the week of October 1st on a bill, HR 1635, that will restrict industrial development bonds (IDBs). These tax-exempt bonds, also referred to as industrial revenue bonds, are used primarily by growing manufacturing firms in need of affordable financing. Many of these firms are small businesses.

IDB opponents are trying to attach HR 1635 to the mortgage revenue bond bill, a bill which is assured of passage this year. If HR 1635 is attached to this bill, IDB opponents will succeed in further restricting IDBs.

To save IDBs, we must prevent the House Ways and Means Committee from attaching HR 1635 to the mortgage revenue bond bill.

HR 1635 must be defeated. If enacted, it would:

--extend the depreciation schedule for facilities financed with IDBs;
--impose a $20 million worldwide capital expenditures test on any company using IDBs;
--impose a $20 million limit on the amount of bonds a firm can have outstanding at any one time; and
--prevent IDB financing for land acquisitions.

In short, the legislation would devastate a program which creates jobs, increases productivity and provides an important incentive for industry to modernize and expand.

CALL FOR ACTION: Small-business owners must immediately contact members of the House Ways and Means Committee, in particular Congressman Shannon (D-Mass.) and Congresswoman Kennelly (D-Conn.), and your own Congressmen and Senators to ask their assistance in opposing HR 1635.

Your letter or mailgram should include:

--opposition to HR 1635 and its removal from the mortgage revenue extension bill;
--benefits of IDBs - creates jobs, increases productivity, increases state and local revenues, provides important incentives to small business to modernize and expand;
--reforms last year - reduced bond volume and eliminated abuses.

Even if you have not been a recipient of IDB financing, write anyway. Many of your colleagues, small-business owners like yourself, have benefited from this program. In addition many distressed areas such as Lowell, Mass., have been revitalized due to IDB financing.

ACT NOW. Write, telegram or call your representative today. Don't let Congress discriminate against small business by severely restricting a financial program that has a proven track record for helping small business.

Please send a copy of your correspondance to SBANE, 69 Hickory Drive, Waltham, BACKGROUND: The key opponent to IDBs is the Treasury Department. They view the restriction and ultimate elimination of tax-exempt IDBs as a means to raise money. However, facts show the bonds cost the federal government little.

The Treasury argues that the federal government loses billions of dollars each year. However, a study by the Congressional Budget Office shows a net revenue gain of only $400 million if the IDB program was eliminated on January 1, 1982. This is a relatively small sum when compared to Treasury standards, and especially when one considers the millions of dollars in state and local revenues generated from the creation of new jobs.

In Massachusetts, a study showed that over a 10-year period the jobs created by IDB-funded projects will produce:

--$6.5 billion in additional personal income;
--$1.3 billion in additional federal and state tax revenue; and
--thousands of indirect new service jobs resulting from increased disposable income.

Below are statistics which illustrate the impact IDBs have had on New England during 1981 and 1982. (Maine statistics unavailable at time of printing.)

State	Projects	Bond Volume	Jobs	
*Connecticut	349	$598 million	37,360	new & retained
Massachusetts	721	997 million	32,359	new
New Hampshire	67	156 million	6,610	new
**Rhode Island	103	247 million	23,700	new & retained
*Vermont	36	53 million	892	new

*Fiscal years 1980-81 and 81-82
**1977-82

During 1977 to 1981, as interest rates rose to unprecedented levels, IDBs provided the only reasonably priced financing available to small business. The IDB program grew substantially during this time.

Last year, the Treasury tried to eliminate IDBs. Fortunately, they were only successful in instituting reforms. These reforms, while eliminating abuses, also reduced the bond volume.

If HR 1635 is passed, the Treasury will get minimal revenue due to decreased bond volume and many small businesses will not be able to take advantage of this tax-exempt financing program.

SMALL BUSINESS PARTICIPATING DEBENTURE
REVENUE ESTIMATE CONSIDERATIONS

1. The criteria for qualification for SBPD's are:

a. Equity capital not to exceed $25 million; and

b. Total debentures outstanding at any one time of no more than $1 million.

2. The essential tax aspects are:

a. A stated interest rate, not to exceed the rate imputed under IRC Section 483, which would be deductible by the borrower and fully taxable to the lender; and

b. A profit participation feature, the payment of which would be deductible by the borrower and taxable to the lender as capital gain.

The first tax element, stated interest, involves no change from present law and should have no revenue effect. The second feature would create a deduction to the borrower (a change from existing law) and capital gain to the lender, thereby reducing the income taxable to the lender by 60% of the amount paid. These changes would reduce tax revenues.

3. Offsetting the tax revenue losses from these changes would be:

a. Taxes on the additional profits generated by the borrower through investment of the funds secured through SBPD's.

b. Taxes on wages paid to persons employed through expansion of business financed by SDPD's.

c. Taxes on profits generated by suppliers of materials and services purchased by the borrower for such expanded operations.

4. The tentative revenue loss calculations made by the Joint Committee are as follows:

		Millions
a.	FY 81	$ 100
b.	FY 82	400
c.	FY 83	1,060
d.	FY 84	1,800
e.	FY 85	2,800

Assumptions made in arriving at these estimates include:

a. Five percent of all eligible firms would participate in fiscal 1981, increasing to 30% by fiscal 1985.

b. The average size of the issue for each participating taxpayer would start at $300,000, increasing to $400,000 by fiscal 1985.

c. The dividend or profit participation element is assumed to be 5% of the face amount of the debenture.

d Twenty-five percent of the SBPD's issued would replace existing debt.

5. On a "worst case" basis, under which the borrower would receive tax benefit from the profit participation element at 46% and the lender would receive tax benefit from capital gain treatment at a 70% rate, the effective tax rate to be applied to the amount of debentures outstanding to arrive at the revenue loss would be 4.6%. Assuming more modest tax benefit factors (a 25% benefit to the borrower and a 35% tax rate to the lender), the overall tax benefit percentage would be 2.3%. Translating this into (1) the number of taxpayers using the small business debenture proposal and (2) the total amount of debentures that must be outstanding to create the revenue losses estimated by the Joint Committee, the following results are determined:

	Fiscal Years				
	81	82	83	84	85
			(Millions)		
JCT Rev. estimate	$ 100	$ 400	$ 1,000	$ 1,800	$ 2,800
Volume ($) of SBPD's required to generate est. losses					
Worst case (÷ by 2.3%)	4,400	17,400	43,500	78,300	121,700
Best case (÷ by 4.6%)	2,200	8,700	21,800	39,100	60,900
If average issue is $400,000 number of companies will be					
BEST -~~Worst~~ case	11,000	43,500	108,800	195,800	304,300
WORST-~~Best~~ case	5,500	21,800	54,400	97,900	152,100

6. These calculations do not reflect additional tax revenues that would be generated from expanded business from the small business sector financed through the small business debenture proposal. If it is assumed that a small business entity can earn pre-tax profits of only 10% of the amount of debentures issued, additional tax revenues would be generated at the corporate level sufficient to offset the revenue loss estimate determined by the Joint Committee. If the business entity can earn 12% on funds received through the small business debenture route, additional corporate taxes would be $3.3 billion for FY 85, roughly $500,000,000 more than the estimated revenue loss.

If we also add the tax that would be imposed at the shareholder level when these earnings are distributed to the owners of the businesses, between $2.2 billion and $2.7 billion could be generated.

STATEMENT OF RONALD B. COHEN, COHEN & CO., CLEVELAND, OHIO, ON BEHALF OF SMALL BUSINESS UNITED, WASHINGTON, D.C.

Mr. COHEN. Thank you.

My name is Ronald Cohen. I am managing partner of a Cleveland, Ohio, CPA firm. Our firm acts as accountants and advisers to approximately 200 small businesses. I am here officially representing Small Business United, an organization consisting of regional groups whose members number in excess of 55,000 small businesses.

One of our big problems is questioning the credibility and objectivity of the Treasury in connection with the revenue estimates. In that regard, I want to thank their representative, who aided us a lot when he stated that the 12 million small businesses in this country represent a particular industry group, and that ACRS was a small business tax measure.

In fact, the purpose of this bill is not to grant tax relief to anyone but to allow for capital creation through the creation of the one remaining source, and that is the individual investors, to move into this area.

Today the restrictive tax laws do not permit this, and what we are asking is not for tax incentives but to remove very unfair tax disincentives, which I elaborate on in my written testimony submitted separately.

Briefly, an individual cannot make a loan because there is no upside to the loan, there is tremendous risk if it's a small business, and if he loses his money there is minimal deductibility. He can't buy stock, because there is no way to get his money out without selling out his holding in the business.

We think the investors in this bill would consist of several groups:

First of all, there are those who are risk takers who would get into some businesses, who are looking to develop a tiny business into a large business. They would obviously be prepared, if necessary, to take losses; but they would be able to extract for their efforts a very substantial profit during the term of their loan.

Second, there would be those very conservative investors who have many sources of funds and substantial funds who would be able to evaluate the collateral provided by a business that needs expansion, which is a developing business, and thereby have an opportunity to increase his yield and in effect gather some additional equity for himself.

Finally, there will be small investment groups formed which will cater to, I believe, small investors or small units, who will be able to go into these partnerships and diversify over many investments.

And finally, a source that has not been mentioned a lot, but the SBIC's and the venture capital companies who today cannot invest in small businesses, because their motivation is to get out in 5 to 10 years. If an individual's goal is not to sell out or go public, there is no interest at all under current legislation for an SBIC or venture capitalist to get in there. This would permit those individuals as well, or those organizations as well, to have that opportunity.

Thank you for the opportunity to testify before you, and I am encouraged by the ad lib remarks that you made in favor of our legislation.

Senator PACKWOOD. I have worked with Senator Weicker a long time on this, so the testimony you are giving is not new to me. We need it for the record, and I appreciate it.

Mr. Pendergast.

[Mr. Cohen's prepared statement follows:]

STATEMENT OF

RONALD B. COHEN

Cohen & Company
Cleveland, Ohio

on behalf of

SMALL BUSINESS UNITED

before the

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

October 28, 1983

Good morning! My name is Ronald Cohen. I am a CPA from Cleveland, Ohio and the managing partner of a local accounting firm, consisting of approximately 30 professional employees and a clientele of several hundred small business entities. I am here today representing Small Business United, an association of whose membership consists of 16 regional organizations, representing between 55,000-60,000 business entities throughout the country.

I appreciate the opportunity to testify here today on behalf of S. 842, legislation permitting the use of Small Business Participating Debentures. Before discussing the merits of this particular legislation, it is important to understand why small business needs some new, creative means of obtaining funds to finance development, expansion and, in some cases, survival.

America became great because of the foresight and courage of two very different segments of our economy. One was represented by the hard-working, innovative entrepreneur and the other by his partner, the wealthy individual or financial institution that supplied funds for new and expanding enterprises. Today, we have plenty of small business owners who can fill the first role as well as ever, but, unfortunately, there are few financial risk-takers willing to support their ventures. The following discussion deals with some of the reasons.

The most common source of funds in the past has been commercial banks, but with the gradual disappearance of the small, locally owned and managed bank, these funds have become less available. Large, structured banks are far less likely to finance closely-held companies than were their owner-managed predecessors.

More and more of the nation's wealth is being accumulated by insurance companies, pension benefits trusts, an other similar institutions. Regulations and traditional investment habits prevent these funds from being directed toward risk situations. In fact, even low risk situations, if they involve small business, are generally not accepted in the institutional market place.

There are a limited number of private venture capitalists. Those that do commit capital to emerging businesses traditionally finance only risk situations with a potential for extraordinary growth, not traditional expansion. Consequently, even when funds are made available, an excessive amount of equity and control must be given to the venture capitalist in order to secure this financing. Many entrepreneurs understandably find these conditions unacceptable.

The motivation for an individual investor to direct his funds towards small business has virtually disappeared. If he wants to become a lender, he would have to charge an incredibly high interest rate to warrant the additional risk he would be taking compared to money market funds or similar investments. Whatever interest rate he earns, however, will be subject to ordinary tax rates. Also, if the investment is bad, he will incur a capital loss which provides relatively little tax benefit to offset the economic loss. On the other hand, should he decide on a purchase of equity, there is no way to realize either return on or return of the investment without either selling the holdings or being penalized by the prohibitive second tax on dividends.

Many of the foregoing comments indicate that the primary need for these funds rests with the brand new or emerging entity. Although it is true that there is a dramatic need to finance those new ventures, there is an even greater need to find funds for the many mature small businesses who must now modernize their plant or desire to expand into new territories.

There are deserving companies who would have no trouble borrowing from banks were it not for the fact that the relatively small size of their loan does not get the attention of the decision-makers at the banks. Systems imposed by the banks today make borrowings for all but the financially strongest companies very difficult. I have enclosed, as an attachment to this testimony, an article describing the plight of the small company trying to borrow from a large bank.

Knowledgeable small businessmen, their advisors and sophisticated investors believe that the SBPD's will finally provide the much needed, new source of capital for small businesses. It appears to solve many of the problems mentioned above. An SBPD offers to the small business capital without the need to give up equity or be required to tap existing sources of debt financing which, even if available, are often unaffordable.

For the investor, an SBPD offers a stated rate of return, plus a negotiatied share of the profits for a limited period of time. It offers them an opportunity to share in the fruits of a potentially flourishing business, virtually unlimited profits in addition to a stated interest rate, taxation of those profits at favorable capital gains rates and limited economic risk (a loss would be minimized by a tax write-off).

Investors could be any individuals who want to invest in the future of America through small business. For example, personal friends or relatives of a particular entrepreneur would be less reluctant to risk their capital in his venture. Banks and insurance companies would be motivated to allocate some of their monies to this exciting segment of the economy. Finally, even the smaller investor could participate through investment partnerships that would probably spring up. These partnerships, mostly sponsored by stock brokerage firms, might sell its units for as low as $5,000. Each partnership would then make many investments, thereby reducing investor risk through diversification. Naturally, the tax attributes of the investments would pass through to the individual partners.

The investor will find that new or expanding businesses will become one of the best places for his money, rather than one of the worst. He will have the benefit of realizing the appreciation of his investment at capital gains rates without having to dispose of it. The potential gain on a successful investment would certainly warrant the risk. Actually, he will have an investment with the security and yield potential of a note, with the upside potential and tax attributes of stock.

For the entrepreneur, SBPD's will make desperately needed funds available for product development, market development, or physical expansion. The typical small businessman will not mind generously sharing his profit, as long as he knows that he is in control of his company and that there is a predetermined method for him to pay off his "partner" when his business can obtain conventional financing or at the maturity of the note.

The only opposition to SBPD's has been based on the mistaken belief that SBPD's would be costly. It is indeed unfortunate that early cost estimates did not take into account the fact that a substantial portion of the funds that would be invested in SBPD's would otherwise be invested in tax shelters or tax-exempts. Furthermore, there has been no consideration in the early cost estimates to any secondary benefits afforded by these investments. It is obvious that no small businessman would ever give a significant portion of this profits to an investor if he didn't need those funds to create or preserve jobs, acquire inventory or equipment, all of which would create a substantial amount of additional Federal revenue.

In summary, let me implore you to give this legislation your earliest and most serious consideration. Here is a bill that can stimulate the economy and reduce unemployment without costing revenues and without involving the bureaucracy. The time has come for the adoption of SBPD legislation.

June 8, 1981 NORTHERN OHIO BUSINESS JOURNAL

Small businessman meets big banker

by Ron B. Cohen

Banks all over the country, including those very large ones with billions in assets, have finally recognized the enormous potential of the emerging small business. These companies offer the banker two major opportunities. First, unlike their experience with large customers, they won't have to compete as strenuously with other banks for the small business account. In fact, all they have to do is be somewhat accommodating, show a little concern, and they will have an insurmountable competitive edge. The other reason is that virtually all large companies were small companies at one time. If a bank can gain the loyalty of the small businessman at the same time it is handling his banking business, the bank's long-range profitability will be greatly enhanced.

R.B. Cohen

In spite of the identification of the market potential, however, most banks have been generally ineffective in exploiting it. The mistake that most banks make is to concentrate a majority of their efforts toward market development and virtually none toward the actual servicing of smaller companies. All of the public relations in the world cannot overcome a lack of proper responsiveness. If a bank obtains a client only because of a strong marketing effort, it can lose that customer to a competitor's marketing effort, but this will rarely be the case if the bank demonstrates its willingness to meet recurring needs.

One of the problems that bankers have is that they are trained to evaluate financial statements as if they were prepared for Fortune 500 companies. Balance sheets and operating statements of firms where all of the shareholders are working employees are different from those where the financial condition and earnings reflect the operation of the business without regard to shareholders' activities. Unfortunately, most bankers fail to make any distinction.

The June 1981 issue of Inc. Magazine features an edited version of a bylined article by Ron B. Cohen, senior partner of Cleveland-based CPA firm, Cohen & Company.

Here is Cohen's article in its entirety.

The separate treatment desperately needed for small business loan applications should be concentrated in three areas:

- The risk-reward factors in loan approvals
- The criteria for loan evaluations
- The effect of tax-related decisions on financial statements.

Without establishing new ground rules for smaller enterprises, banks will never adequately provide the necessary debt capital needed by this country's small businesses to play their critical role in our nation's economic recovery.

The most serious defect in the system is in the risk-reward functioning of loan approvals. If a loan officer makes a marginal loan, which causes the business to grow and prosper, the bank gets a loyal, long-range, profitable customer. Unfortunately, the originating loan officer gets little or no recognition. However, should he make a loan that becomes a problem, he is usually subjected to severe criticism. The loan does not have to go bad, or even become classified as doubtful; all that is needed to make the loan officer look bad is for some independent third party to make a purely objective evaluation of what appears to be the facts, such as financial statement data.

Because of this process, loan officers, sometimes even top people at the bank, have a difficult time making a marginal loan because there is nothing to gain and everything to lose. Consequently, a small emerging businessman gets shut out again. Although specific examples of this are difficult to find, I do know of one very illustrative case related to me by a colleague.

It seems that his biggest client had a new product that he had previously developed and went to his bank to borrow $150,000 to implement his marketing plan. His only meaningful collateral was out-of-state real estate, owned by a relative that had wall over $500,000 in equity. The loan officer didn't want to try to make an exception to bank policy by using out-of-state property as collateral and used that as an excuse to say "no". Later, with a very prosperous business providing him an upgraded life style, this entrepreneur joined an exclusive country club, the same one the president of his old bank belonged to. When the banker began soliciting his business, he was told that the company had always dealt with the bank, but was forced to switch when his seed money loan for the new product was turned down. Wanting a little "I told you so" gratification, he challenged the bank president to verify the circumstances with the old loan officer, now a high ranking bank executive. When the businessman followed up, he found out that the loan officer's notes stated that he thought the world of the potential, but that the risk made the loan unwarranted. So the president complimented his subordinate for both being astute enough to recognize the upside and for his proper motivation in wanting to conserve the bank's assets. The truth is that his bad decision vindicated his judgement where in another case, he could have been severely criticized for having to "work out" a difficult loan. For most loan officers, "no" is the only safe answer.

Big banks also miss the boat on the small business customer because of the manner in which loan applications are evaluated. There are four criteria that my experience has shown me are prerequisites to loan approvals. These criteria are applied to all loan applications and most companies must meet all four. Three of the criteria are very valid; namely, good credit and character, a valid business purpose for the loan, and adequate security. I would never recommend to any bank that it have a policy of lending money where any one of these criteria is not met. However, the banks usually insist upon a fourth requirement, which in the case of many small businesses turns out to be the killer. This is the demand for proof of a demonstrated ability to repay the loan. By demonstrated ability, I am not referring to a projection based

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Small businessman meets big banker

on future expectations, which would be a reasonable requirement, but to the ability to make future loan repayments based on prior experience. A common instance where it is impossible to demonstrate such ability is the expansion loan where the increased productivity of the business is needed to generate enough money for debt service.

In a typical recent situation, an expansion-minded client had ongoing operations generating $50,000 of excess cash flow available for debt service. The expansion called for a loan of $300,000 with a debt service requirement of about $80,000 for a five-year period. The borrower's projections showed that the expansion would increase cash flow from $50,000 to $200,000, but the bank considered that to be conjecture, not supported by historical performance: It turned down the loan because it could only count on $50,000 per year. Remember, the borrower had already established that there was a good purpose for the loan (the expansion was appropriate and reasonable) and the existence of adequate security (the $300,000 loan was to have been secured by other equipment in the company as well as by guarantees of the shareholders).

Unfortunately, the bank was impossible to satisfy. When we made the argument that if expectations fell short, the bank would be protected by the adequate collateral, the answer was that the bank was not in the foreclosure business. In reality, our client (he had proven credit and reputation) would never have waited for foreclosure, but would have voluntarily liquidated enough assets or obtained outside investors to cover the balance of his obligation should the venture become unsuccessful. But this, too, was ignored because this banker was prepared for all contingencies, including changes in character. The ironic part about this is that if this same client wanted to buy a yacht or an airplane for personal use, the bank would not think twice about lending most of the cost of this acquisition based on values that could be looked up in a book. Personally, if I were a banker, I would rather loan to a businessman who is putting his time as well as his profits back into his business instead of removing both be acquiring a personal luxury.

The most frustrating problem results from the tax-related decisions made by the owner-managers. I remember a conversation with a banker several years ago while we were reviewing a client's balance sheet. I was trying without success to explain our recent LIFO election that reduced inventory valuation by $100,000, reducing the income tax liability by $50,000. Naturally, this had a $50,000 impact on net worth and, incredibly, the banker was being very critical of our treatment. He would have rather seen the higher net worth and the higher inventory reflected in spite of the tax cost. I guess, by his reasoning, his loan was made more secure by having the same assets listed at higher values. In another situation, a banker wanted us to capitalize, instead of writing off, a borderline expenditure. He told me that the resulting improvement in the balance sheet and operating statement would help him in justifying the loan. Why bankers believe that eliminating corporate assets (taxes paid) actually improves their security is a mystery to me.

In our practice, the best example of the on-going disputes we have with bankers are not in the areas of LIFO and expense vs. capital items, but in the area of compensation. We take an extremely aggressive approach as to the amount of compensation. We take an extremely aggressive approach as to the amount of compensation to which an officer is entitled. We don't want him to take one penny less, profits permitting, than what would be deemed reasonable for tax purposes. The object, to whatever extent it can be controlled, should be to reduce the overall tax burden (the combined shareholder-employee and corporate tax) to the lowest possible level in order to increase overall cash flow. In the typical situation, these funds are still available for debt service and other business needs.

The problem with the banks arises with rapidly growing companies. Increasing the inventory, equipment, and receivables accelerates the need for both equity and debt financing, while the bankers think the highly paid officers are draining the company. What is actually happening is that the large salaries are reducing corporate taxes, while substantial portions of them are lent back. In many cases, the compensation at the financial statement data is accrued but not paid, creating not only a corporate tax savings, but a personal tax deferral, resulting in still greater cash availability. In reality, the bank's position has been aided, not hindered. By requiring that a portion of salaries be loaned back and subordinated, that accrued salaries be subordinated or personal guarantees be made, banks can easily be protected in those rare situations where there is an actual risk of dissipation of collateral.

I am hoping that someday the banks will discover the real entrée into the small business market and change their loan approval procedures. Why don't you help by sending a copy of this article to your banker?

— Ron Cohen

STATEMENT OF EDWARD H. PENDERGAST, PRESIDENT, FINANCIAL MANAGEMENT AND CONSULTING CORP., BOSTON, MASS.

Mr. PENDERGAST. Thank you, Mr. Chairman.

My name is Edward Pendergast. I am here as a small business activist. I was a delegate to the White House Conference on Small Business and a member of the Capital Formation Task Force that considered the small business participating debenture, and recently was a member of a capital formation advisory group to the SBA.

I was interested in hearing the Assistant Secretary talk about their reaction to this bill. I have been a small business activist for 20 years and somehow or other they changed the names, but the words come out the same from the Assistant Secretary of the Treasury for Tax Policy: they are always No, and very rarely any consideration of any dynamic aspects of legislation.

I sat down after having seen revenue estimates and decided to see if I could set up a computer model that was based on the IRS statistics themselves, to see if we could come up with figures that would be anywhere near revenue estimates that we have seen projected.

As we looked at it, we decided that it was probable that the dollar impact of unincorporated companies in the SBPD would be relatively small, because their economic impact is less. Also, most people who are lending to small business prefer to lend to an incorporated entity. So the model is limited to corporations.

Under the assumptions I have made—and if you look at exhibit 1 of my testimony, you will see an outline of the assumptions that I have made—I started out with one basic assumption, that the only reason a company is going to enter into debt with a small business participating debenture is that they hope to invest that money to yield more than the cost of the money. And no revenue estimate I have seen has made that assumption.

I have said let's assume that a corporation will make some money on that debenture. First, if they don't make any money, the maximum revenue impact I have been able to find is $179 million. If they made 10 percent as a return on the moneys they have invested by borrowing that, the revenue enhancement to the Treasury would be $277 million.

There are ways to make it more or less by different assumptions, and I was hoping that Treasury would come in with some detail so my computer model, which I have here, could have been modified to address the Treasury.

Senator PACKWOOD. I think your problem with Treasury is, they just don't like the philosophy of the bill.

Mr. PENDERGAST. They also don't like to disclose how they calculate their revenue losses, because it might be challenged.

Senator PACKWOOD. No, but that is not unique to this bill. We have discovered that applies to bills that involve billions and billions of dollars. Assuming that everything goes wrong, and our estimates are terrible, the revenue loss is comparatively small—if there is a loss. Yet we have had the same difficulty with Treasury on estimates on their own tax bills. You are talking about tens of billions of dollars, in trying to figure, "How did you get from A to Z on the estimate?"

Mr. **Pendergast**. Are you asking me that question?

Senator **Packwood**. No, I am just talking about the Treasury.

Mr. **Pendergast**. I have shown the A to Z.

Senator **Packwood**. I want you to continue, because I have often discovered that many of these bills die or pass solely on the basis of revenue estimates, assuming that the committee is favorable to the philosophy. If you haven't gotten over that hurdle, we don't go anyplace, anyway.

But beyond that, and especially when we are talking about $200 billion deficits, this is not a propitious time to be adding new bills if we cannot convince people there is no revenue loss or that it is de minimus.

Mr. **Pendergast**. OK.

Let me tell you something else about them. If a company has borrowed $100,000 and yields as little as 4 percent for their own as a return on the investment, in fact the revenue loss is zero—it's a break-even situation.

In fact, looking at the statistics from the IRS, companies earn on the average of 7 percent on the return on borrowed money; which means that at that point there would be some $100 million additional revenue to the Treasury.

Another thing that is not considered here is the increased economic activity from the investment that the companies have added.

And further, something else that I can't calculate without an economist to help me, is: "What is the job generation effect of a company getting additional funds to operate with?" I haven't taken that into consideration, because I don't feel competent to; but it is another factor that would create significant additional revenue for the Treasury.

Any time that you make a projection that there is going to be a capital gain generated, which is a concern that Treasury has, that means there have been profits generated by the corporation. And you need to take that into consideration as a balancing factor, because that means there is additional tax revenue from those additional profits. And my assumptions I think have fairly clearly outlined, say, that the corporation might make as much as 10 percent, and then we would have that revenue enhancement of $277 million.

[Mr. Pendergast's prepared statement follows:]

Statement by:

Edward H. Pendergast

President

Financial Management and Consulting Corporation

before

United States Senate Finance Committee

Subcommittee on Taxation and Debt Management

Washington, D.C.

October 28, 1983

Mr. Chairman, thank you for this opportunity to address the issues of Small Business Capital Formation. My name is Edward H. Pendergast. I am a financial consultant to small business and my background includes many years as a small business activist as can be seen from my attached resume. I have served as a president of the Smaller Business Association of New England, been a delegate to the White House Conference on Small Business, am a member of the American Institute of CPA's Small Business Committee, Vice Chairman of the Small Business Foundation of America and Chairman of Massachusetts' Governor's Small Business Advisory Council.

First I would like to commend the Senate Finance Committee's Subcommittee on Taxation and Debt Management for holding these hearings and for the initiatives it has taken to facilitate small business access to capital. Your interest in Capital Formation for Small Business and specifically your consideration of S842, the Small Business Participating Debenture Bill, is well worth the time you are committing to this effort.

It is not necessary to repeat what others have said about the importance of small business to our country. Suffice it to say that new job generation and successful exploitation of new technology have been unique characteristics of the small business. A quote relating to new business was helpful to me. "New businessess add products and services that improve choices for consumers and build competitive strengths for the nation against foreign rivals. Entrepreneurial ventures provide a competitive spur to existing companies, both large and small, stimulating them to improve quality and reduce prices to the benefit of buyers. They accelerate the advance and dissemination of new technologies which enhance national defense and the quality of life at the same time. The new jobs they create provide more alternatives for employment, particularly for many individuals who have difficulty finding or fitting into the rigid slots of established organizations. New ventures are territory essential for the pursuit of happiness by many. Through entrepreneurship more people become leaders and economic power becomes more decentralized, broadening the base for a democratic economy."(1)

Too often the problems of capital retention are confused with those of capital formation. True capital formation issues are relatively rare. The reduction in the capital gains tax enacted by Congress two years ago has stimulated a tremendous growth of new venture capital. The current quickening of the pulse obscures the real problems. First, only glamorous issues easily attract the needed capital whether in the public or private marketplace. Many good, solid business opportunities go begging because the earnings multiples are not outrageous enough. Second, with all the talk about venture money, private venture capital companies have about $7.6 billion in capital and actually invested only $1.8 billion in the last year. Underwritings for companies with net worth of $5 million or less totalled about $620 million. This total of the of $8.2 billion is less than one mutual fund operation,

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(1) Karl H. Vesper, "entrepreneurship and National Policy" Heller Institute for Small Business Policy Papers, 1983.

Fidelity, has in its cash management fund, never mind its other funds. Further, as a percent of the total equity money available, small business receives a pitifully small amount, probably less than 10% for the 92% of businesses that have less than $5 million in assets even though these businesses generate 30% of gross receipts.(2)

The Small Business Participating Debenture (SBPD) is the only major new true capital formation initiative that seems plausible. You have heard detailed testimony from the members of the panel reviewing the history and many of the arguments in favor of the SBPD. There does not seem to be any real opposition except for revenue estimates which I will address in detail. The secondary objection seems to center around abuses. Mr. Barth has suggested remedies for this concern that would eliminate tax shelter schemes from eligibility. The purpose behind SBPD is to create capital not beg taxes. Creation of capital creates jobs and profits which in turn generate revenues for the Treasury. Another objection is that SBPD would replace existing debt. In order for this to happen, the creditor would have to be interested in the capital gains aspect of the investment. The vast majority of existing debt is bank debt. Banks pay tax at a lower average rate than the corporate capital gains tax which may explain why banks' capital gains represent only 3% of banks' total taxable income.

As to the revenue estimates, the SBPD legislation has been plagued by inexplicably high revenue loss estimates. No explanations of assumptions have been forthcoming. Any assumptions need necessarily be complex and arbitrary so this is not in itself a barrier to discussion. We do need to see these assumptions to have a chance to test the reasonableness of them. For example, as Mr. Haddad has testified, the revenue impact of Senator Tsongas' New Venture Investment Incentive Act (NVII) were calculated as well below those of SBPD in spite of the fact that NVII calls for an initial complete write-off of the investment!

To try to address this, I decided to develop a model that would calculate revenue estimates. Attached as Exhibit 1 are my conclusions of the revenue impact of the SBPD. I eliminated unincorporated entities from my calculations because, although they are large in number, their economic impact on the Treasury would not be significant and participation by lenders is apt to be quite small since lenders prefer to lend to corporations and require personal guarantees of the principal shareholders. My computer model is designed to allow for any changes in the assumptions that have been made. It assumes that stated interest on the debentures will have no revenue impact since this is no change from current law. The only difference is the extra "interest" element that is paid out of profits generated from the SBPD which are deducted as ordinary expenses by the corporation and recorded as capital gain by the investor.

(2) These are estimates from IRS data for corporations. Individuals proprietorships are not included. If they had been the figures would have been even smaller.

The IRS' statistics are, as always, lacking when you try to make good estimates. The SBPD bill limits this type of investment to companies with less than $10,000,000 of equity but the IRS statistics of income are classified by size of assets. To address this, I calculated the average equity of categories of corporations by asset size and concluded that corporations with assets of less than $25,000,000 included the corporations with equity of $10,000,000 or less.

It is evident to me that the only reason a business would agree to an SBPD with an investor would be because the business expected to realize a profit for the business on the use of the borrowed funds over and above the cost of those funds. This additional profit would create taxes for the Treasury at the corporation's normal corporate tax rates. Using my assumptions, the corporations would only have to earn 4% on the borrowed funds in excess of the cost of these borrowed funds for the SBPD to be a break even revenue estimate! During 1980, these corporations on the average earned 7.6% on borrowed funds. At a 7.6% rate, SBPD's generate $145,400,000 of tax revenues! None of these calculations take into consideraton the fact that the increase in economic activity from the funds generated by the investment of an SBPD will create jobs, particularly in the small business which is more labor intensive than the large businesses.

On my assumptions, the worst case which assumes the corporation does not earn any money on the SBPD, the revenue loss in the 5th year would be $179 million. If it earned 10%, the revenue gain would be $278 million. To evaluate the possibility of reducing the size limits of eligible corporations, I modeled the affect of eliminating the corporations with assets of $5,000,000 or more which might be equivalent to corporations with equity of $2,000,000 or less. This analysis is included as Exhibit 3. The worst case revenue loss is $113 million. Assuming the corporation earned 10% of the face of the debenture, the revenue gain would be $142 million.

My conclusion is, absent any other analysis of actual data and a responsibly explained revenue estimate from Treasury, the SBPD will at worst probably cost the Treasury nothing. At best, and this is highly probable, the SBPD will generate significant revenues even without analyzing the job generation effect of the SBPD. If that job generation effect could be measured, I suspect the SBPD would turn out to be one of the most exciting and rewarding pieces of economic legislation that this country has seen.

I will be happy to adjust my computer model to alter any of the assumptions I have made.

My recommendation is that the SBPD be enacted after Mr. Barth's recommended changes to eliminate possible abuse and that the size limit be started at $5,000,000 of equity until the impact is observable. This would require the IRS to monitor the affect of the SBPD. One the positive aspects of the SBPD could be measured, consideration could be given to raising the limits.

The committee should be congratulated on holding this hearing. I hope you will recommend the SBPD to the entire Senate.

EXHIBIT 1

Revenue Impact of the Small Business Participating Debenture

prepared by: Edward H. Pendergast - October 28, 1983

The estimated revenue gains or (loss) for each of the first 5 years is as follows ($ in millions):

	Assume Corporation's Earnings on the Debenture *	
Year	0%	10%
1	$(23.9)	$ 37.0
2	$(47.7)	$ 74.1
3	$(83.6)	$129.6
4	$(119.4)	$185.2
5	$(179.1)	$277.8

*After payment of a profit participation to the debenture holder of 5% of the face of the debenture.

The revenue impact in the fifth year if the size limit was reduced to $5 million in assets would be $(65.2) million and $61.9 million respectively.

The assumptions are based on IRS' 1980 Statistics of Income. In addition the following assumptions are made:

1. The average SBPD will be $5,000 for companies with less than $100,000 in assets, the $1,000.000 maximum for companies with $5,000,000 to $25,000,000 in assets and 10% of assets for all other corporations.

2. The average profit sharing portion will be 5% of the face amount to the holder of the SBPD even though many companies will not earn enough to pay a profit share to the investor.

3. Number of corporations using the SBPD will rise from 2% in the first year to 15% in the fith year.

4. The revenue in the first column above is the 30% difference between maximum ordinary tax rate of 50% and maximum capital gains rate of 20%.

5. The revenue gain in the second column is the tax on a 10% earnings by corporations on the face of the SBPD less assumption 4.

The attached EXHIBIT 2 shows year 5 with these assumptions. EXHIBIT 3 shows these assumptions eliminating corporations with assets in excess of $5,000,000.

Revenue break even is achieved in year 5 when assumption 5 earnings are as low as 4.1%. At the corporations' average net on assets as shown on the table, the revenue gain is $145.4 million.

EXHIBIT 2

YEAR NUMBER 5

REVENUE GAIN (LOSS) ESTIMATES FOR THE SMALL BUSINESS PARTICIPATING DEBENTURE(SBPD) SBPD1
DOLLAR AMOUNTS ARE IN THOUSANDS UNLESS STATED
prepared by E.H.Pendergast as of October 25,1983

SIZE RANGE	AVER ASSETS(1	NUMBER OF CORPORATION	CORPORATIONS TO USE		AVER FACE OF SBPD(2	TOTAL FACE OF SBPD	PROFIT SHARE(3	TAX IMPACT OF SHARING PROFITS			TAX FROM EARNINGS(7	REVENUE GAIN(8
			PERCENT	NUMBER				C.G.(5	ORDINARY(6	NET		
<$100	$38	738,711	15%	110,807	$5	$554,033	$27,702	$5,540	$13,851	$8,310	$8,310	$0
<$500	$235	526,953	15%	79,043	$24	$1,858,621	$92,931	$18,586	$46,466	$27,879	$33,455	$5,576
<$1,000	$697	137,827	15%	20,674	$70	$1,440,765	$72,038	$14,408	$36,019	$21,611	$43,223	$21,611
<$5,000	$2,019	122,405	15%	18,361	$202	$3,707,850	$185,393	$37,079	$92,696	$55,618	$170,561	$114,943
<$10,000	$7,005	16,568	15%	2,485	$1,000	$2,485,200	$124,260	$24,852	$62,130	$37,278	$114,319	$77,041
<$25,000	$15,857	12,605	15%	1,891	$1,000	$1,890,750	$94,538	$18,908	$47,269	$28,361	$86,975	$58,613
TOTAL	$522	1,555,069	15%	233,260	$51	$11,937,219	$596,861	$119,372	$298,430	$179,058	$456,843	$277,785

ASSUMPTIONS

1.AVERAGE ASSET SIZE AND NET INCOME IS CALCULATED FROM IRS STATISTICS
FOR 1980 FOR CORPORATIONS WITH NET INCOME

CATEGORY	TOTAL NO. CORPS.	TOTAL ASSETS$	TOTAL EQUITY$	AVERAGE EQUITY	AVER. ASSETS	TOTAL NET INC.$	AVER NET INC.	TAX BRACKET	NET AS % OF ASSETS
<$100	738,711	$28,079	$11,581	$16	$38	$3,470	$5	15%	12%
<$500	526,953	$123,908	$56,782	$108	$235	$11,388	$22	18%	9%
<$1,000	137,827	$96,051	$40,687	$295	$697	$7,492	$54	30%	8%
<$5,000	122,405	$247,190	$98,244	$803	$2,019	$19,585	$160	46%	8%
<$10,000	16,568	$116,061	$43,861	$2,647	$7,005	$8,757	$529	46%	8%
<$25,000	12,605	$199,878	$62,201	$4,935	$15,857	$10,949	$867	46%	5%
TOTAL	1,555,069	$811,168	$313,356	$202	$522	61,641	$40	18%	8%
FOR<5,000	1,525,896	$495,229	$207,294	$136	$325	$41,935	$27	18%	8%

$THESE AMOUNTS ARE IN MILLIONS

2.AVERAGE SBPD IS ASSUMED TO BE $5,000 FOR FIRST CATEGORY
10% OF ASSETS FOR NEXT THREE CATEGORIES
$1,000,000 FOR THE LAST TWO CATEGORIES,SINCE THIS IS THE LIMIT

3.PROFIT PARTICIPATION IS ASSUMED TO 5% OF THE FACE AMOUNT OF THE DEBENTURE

4.PERCENT OF CORPORATIONS USING THE SBPD WILL BE

IN FIRST YEAR	2%
SECOND YEAR	4%
THIRD YEAR	7%
FOURTH YEAR	10%
FIFTH YEAR	15%

5.SBPD TAX IS ASSUMED TO BE DUE AT THE MAXIMUM CAPITAL GAIN RATE OF 20%

6.NORMAL TAX IS ASSUMED AT 50%

7.CORPORATIONS EARN 10% OF FACE OF DEBENTURE TAXED AT BRACKETS USED IN ASSUMPTION 1

8.REVENUE (LOSS) OR GAIN IS DIFFERENCE OF TWO PRECEDING COLUMNS

EXHIBIT 3

YEAR NUMBER 3

REVENUE LOSS ESTIMATES FOR THE SMALL BUSINESS PARTICIPATING DEBENTURE(SBPD)
DOLLAR AMOUNTS ARE IN THOUSANDS UNLESS STATED
prepared by E.M.Pendergast as of October 25,1983

SBPD1

SIZE RANGE	AVER ASSETS(1	NUMBER OF CORPORATION	CORPORATIONS TO USE PERCENT	CORPORATIONS TO USE NUMBER	AVER FACE OF SBPD(2	TOTAL FACE OF SBPD	PROFIT SHARE(3	TAX IMPACT OF SHARING PROFITS C.G.(5	TAX IMPACT OF SHARING PROFITS ORDINARY(6	TAX IMPACT OF SHARING PROFITS NET	TAX FROM EARNINGS(7	REVENUE GAIN(8
<$100	$38	738,711	15%	110,807	$5	$554,033	$27,702	$5,540	$13,851	$8,310	$8,310	$0
<$500	$235	526,953	15%	79,043	$24	$1,858,621	$92,931	$18,586	$46,466	$27,879	$33,455	$5,576
<$1,000	$697	137,827	15%	20,674	$70	$1,440,765	$72,038	$14,408	$36,019	$21,611	$43,222	$21,611
<$5,000	$2,019	122,405	15%	18,361	$202	$3,707,850	$185,393	$37,079	$92,696	$55,616	$170,561	$114,945
TOTAL	$325	1,525,896	15%	228,884	$33	$7,561,269	$378,063	$75,613	$189,032	$113,419	$255,550	$142,131

ASSUMPTIONS

1.AVERAGE ASSET SIZE AND NET INCOME IS CALCULATED FROM IRS STATISTICS FOR 1980 FOR CORPORATIONS WITH NET INCOME

CATEGORY	TOTAL NO. CORPS.	TOTAL ASSETS*	TOTAL EQUITY*	AVERAGE EQUITY	AVER. ASSETS	TOTAL NET INC.*	AVER NET INC.	TAX BRACKET	NET AS % OF ASSETS
<$100	738,711	$28,079	$11,581	$16	$38	$3,470	$5	15%	12%
<$500	526,953	$123,908	$56,782	$108	$235	$11,388	$22	18%	9%
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TOTAL	1,555,069	$811,168	$313,356	$202	$522	61,641	$40	18%	8%
FOR<5,000	1,525,896	$495,229	$207,294	$136	$325	$41,935	$27	18%	8%

*THESE AMOUNTS ARE IN MILLIONS

2.AVERAGE SBPD IS ASSUMED TO BE $5,000 FOR FIRST CATEGORY
10% OF ASSETS FOR NEXT THREE CATEGORIES
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6.NORMAL TAX IS ASSUMED AT 50%

7.CORPORATIONS EARN 10% OF FACE OF DEBENTURE TAXED AT BRACKETS USED IN ASSUMPTION 1

8)REVENUE (LOSS) OR GAIN IS DIFFERENCE OF TWO PRECEDING COLUMNS

EXHIBIT 4

EDWARD H. PENDERGAST, C.P.A.

Financial Management and Consulting Corporation
One Faneuil Hall Marketplace
Boston, Massachusetts, 02109
(617) 720-0400

PROFESSIONAL EXPERIENCE

Consulting. President and Founder of Financial Management and Consulting Corporation since 1979. The company serves as financial advisor to growth oriented businesses.

Small Business. Elected President of the Smaller Business Association of New England (SBANE) in 1972 after serving in a variety of roles advocating the needs of small business. Served on Secretary of the Treasury's Small Business Advisory Committee as Chairman of the Tax Policy Subcommittee. Currently serving as Vice-Chairman of the Small Business Foundation of America, Inc. and Chairman, Massachusetts Governor's Small Business Advisory Council.

Public Accounting. Founded CPA firm of Pendergast, Creelman and Hill. Merged with the international CPA firm of Hurdman and Crantoun becoming partner-in-charge of the Boston and Maine offices. Appointed National Director of Planning. National responsibilities included mergers, acquisitions and marketing. Withdrew in 1979 to form Financial Management and Consulting Corporation.

Education. Develops and teaches courses in problems of closely-held family business and financing and tax planning for the small business.

Arbitrator. American Arbitration Association - Member of Commercial Panel.

PROFESSIONAL ASSOCIATIONS

Smaller Business Association of New England - President 1972-1973, Member of the Board of Directors 1978-1981, currently member of taxation committee.
Massachusetts Society of Certified Public Accountants - President 1977-1978, currently member of legislature and small business committees.
American Institute of Certified Public Accountants - Currently member of Small Business Committee and Past Member of Governing Council.
American Association of Accountants

EDUCATION

Bachelor of Science in Accounting, Bentley College
Master of Science in Taxation, Bentley College
Certificate of Advanced Graduate Study, Northeastern University Graduate School of Business Administration

July 11, 1983

Senator PACKWOOD. Gentlemen, I have no questions. Having been in the Senate long enough, I realize that these new ideas take some degree of incubating; although this idea is not new. Lowell has been kicking it around now for 4 or 5 years. In my mind the evidence is becoming more and more conclusive that it will work.

I was intrigued by the evidence in the statement about the Wisconsin bank. That was new to me; I had not seen that before. It is interesting evidence, but I don't want to say conclusive. I support the bill. It is something like this, and will indeed work as intended.

I suppose if you don't want to help small business, if you want to tilt away from it or be neutral, then you are saying that we are going to put the new little business in the same pocket with General Motors. Then the bill doesn't get passed and you let the market determine how it is going to go regardless of size. But I don't think that's the intended philosophy at least of this Congress.

Mr. BARTH. Mr. Chairman?

Senator PACKWOOD. Yes, sir.

Mr. BARTH. The Milwaukee bank also reported that two of the few loans that they made saved family-owned businesses as a closely held company, that the alternative was merger and further concentration. And through two of its loans, it saved two small businesses in Milwaukee.

Senator PACKWOOD. I would wager you couldn't find 1 person in 10 in Congress that says they don't want to help family businesses. Indeed, we have attempted to pass the estate tax changes and other legislation with that very philosophy in mind. So it is neither foreign to us in terms of our rhetoric nor in terms of our actions.

Mr. COHEN. Mr. Chairman?

Senator PACKWOOD. Yes.

Mr. COHEN. In connection with the revenue, I would like to add that logic demands that you assume that the businesses are going to take any money that they are going to borrow by giving up a percentage of the profits in their business, and put those moneys either into new employees, new inventory, new capital goods, or whatever.

Furthermore, the idea that much of the source of the funds will provide an alternative to individuals to tax shelters or tax exempts. And even though they are paying favorable capital gains rates, you may have people paying taxes on income that they otherwise would not have had taxed at all.

Senator PACKWOOD. I agree with you completely.

Mr. HADDAD. Mr. Chairman?

Senator PACKWOOD. Go right ahead. Yes.

Mr. HADDAD. I have one last comment.

In one of my analysis I presented an exhibit comparing a bill—just to get to the question of the revenue study by the joint committee.

There was a bill submitted which provided for a direct writeoff of an investment in a small business, as opposed to an SBPD which merely provides——

Senator PACKWOOD. Was this the Tsongas bill?

Mr. HADDAD. Yes, the Tsongas bill. That bill showed a negligible revenue loss; yet, in a simple example of a $30,000 investment, there was a $15,000 immediate revenue loss, which wouldn't be recouped by Treasury until 5 years down the road. A $30,000 investment in an SBPD results in no immediate revenue loss, if you assume all other factors are constant, which they should be between the two investments.

It makes no sense to us at SBANE how that result could occur.

Senator **PACKWOOD**. You would have a smaller revenue loss from the Tsongas bill?

Mr. **HADDAD**. That is correct.

Senator **PACKWOOD**. I agree. I noticed that when I read through your statement, I had not had that point called to my attention before. I will follow up on it and find out what the base was, and how they came to the two different conclusions.

Mr. **HADDAD**. A constant investment and no tax benefits are more than one issue.

Senator **PACKWOOD**. I agree.

If anything, it ought to be the reverse, in terms of the two bills.

Mr. **HADDAD**. That is correct.

Senator **PACKWOOD**. Gentlemen, thank you very much for coming.

Mr. **HADDAD**. Thank you.

Mr. **BARTH**. Thank you, Senator.

Senator **PACKWOOD**. We will now move on to S. 499, and a panel of R. Scott Clements, J. A. Garrett, and Martin Orr.

It is good to have you with us.

Mr. Clements is a constituent of mine, the president of Clements-Marshall in Portland, and he is also the chairman of the Oregon Municipal Debt Advisory Committee and the president and presiding director of the Oregon Economic Development Corp. So he comes with a great deal of practical and political experience.

Mr. Clements, go right ahead.

STATEMENT OF R. SCOTT CLEMENTS, ORGANIZING DIRECTOR, OREGON SMALL BUSINESS DEVELOPMENT CORP., PORTLAND, OREG.

Mr. **CLEMENTS**. Good morning, Mr. Chairman.

I would like to thank you on behalf of Governor Atigeh for the opportunity to appear before your committee this morning.

Senator **PACKWOOD**. I don't know if you were here. I have put his letter in the record.

Mr. **CLEMENTS**. I did hear that, sir. Thank you.

I would like to file my formal remarks for the record and condense my comments into simply an update of what we are doing in Oregon that relates to S. 499, and the reasons behind our action.

Senator **PACKWOOD**. All of your statements will be in the record in full.

Mr. **CLEMENTS**. Thank you, sir.

This has been an active year in Oregon. We have created a statewide 503 corporation, which is still in its very early stages. And during this same year, in an effort to make industrial development bonds available to small business, we have taken the first steps toward the creation of an umbrella bond program which would authorize issuance of industrial development bonds in amounts less than $1 million, and would provide a vehicle to do so at an economical cost.

The reasoning for doing this, as you are aware, is that the State of Oregon has been in a very depressed situation for the last 3 years. We are extremely excited by the prospects of the 503; used in conjunction with the industrial bond, it is of genuine value.

The 503 program is unique in its subordination provisions, which allow and encourage the private sector to do additional capital funding.

The industrial development bond itself is a natural ancillary tool to be used, and I would take issue with the Treasury when they referred to these two instruments as being duplicative. In fact, they are complementary.

The last point I would like to make, Senator, is that I think, in terms of what the future holds as far as the State of Oregon, it is very closely tied to our ability to access new sources of capital, and the provisions of 499 will permit both instruments to be used together in a complementary fashion, which will accomplish more than either of the instruments used alone.

Thank you very much.

Senator PACKWOOD. Thank you very much.

Mr. Garrett.

[Mr. Clements' prepared statement follows:]

STATEMENT OF

R. SCOTT CLEMENTS

President, Clements, Marshall & Co.
Portland, Oregon

and

Chairman, Oregon Municipal Debt Advisory Commission

and

President and Presiding Director
Oregon Economic Development Corporation

before the

UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Taxation and Debt Management

October 28, 1983

Good morning, Mr. Chairman and distinguished Committee members. My name is Scott Clements and I am a resident of ~~Porland~~ Portland, Oregon. I wear a variety of hats in Oregon which account for my appearance before you this morning in regard to S.499. I am President of Clements, Marshall & Co., an independent financial advisory firm which serves as financial advisor to a variety of private and public sector clients, including the Oregon Department of Economic Development and several other State agencies. I also serve as Chairman of the Oregon Municipal Debt Advisory Commission, an appointive body which, together with the State Treasury, serves in an advisory capacity to Oregon local governments in the areas of debt policy, management and issuance. Finally, and the primary reason for my presence here today is my role as President and Presiding Director of the Oregon Economic Development Corporation, a statewide SBA 503 development corporation recently organized under the sponsorship of Governor Atiyeh.

In approaching S.499, I will attempt to:

* identify the policy issues and goals involved in the IDB and 503 programs.

* describe what we are doing in Oregon in response to those perceived issues and objectives.

* put into context, the importance of IDB financing for small business versus perceived costs.

* provide some concluding observations.

Job creation and maintenance are generally characterized as the public policy justification for IDB's and federal business support programs. Jobs, however, follow productivity.

High levels of productivity directly benefit U.S. producer's competitiveness in both the domestic and international markets, and historically productivity has been positively correlated with the ~~role~~ level of capital investment. The post-World War II U.S. history in terms of the average annual increase in productivity growth is as follows:

1947-1967	3.3%
1967-1977	1.8%
1977-1982	.8%

By comparison, during the 1977-82 period, productivity in Japan grew at a 5.6% annual rate. The reasons for this disparity in growth rates are varied, but the result of this slowing in U.S. productivity growth has been dramatic and predictable. Imports have risen as a percent of total U.S. sales. Comparing imports in 1960 versus 1982:

	1960	1982
Autos	8%	28%
Steel	5%	22%
Apparel	6%	15%

In recognition of the need for capital investment to stimulate economic growth and development, the various levels of government have attempted to encourage investment through a variety of programs. IDBs represent one vehicle utilized, primarily by the various states. The 503 program represents a similar response by the federal level directed at small business. I would suggest that IDBs and the 503 program are directed at the same public policy objective, stimulating capital investment.

Through the process of subordination, the 503 program provides a unique function. It creates a "surrogate" or substitute form of equity. This is of little value to the large, ~~publically~~ Publicly traded company because it can raise equity capital through the marketplace, whenever it chooses.

The small business is typically privately held, and as a result, does not have the same capital market access. Therefore, the 503 program, through subordination, serves an essential function in encouraging private sector lenders to participate in funding additional small business investment. The issue as to the form private sector investment takes is not material to achieving the stated public policy goal, it is only important, as a matter of principal, to certain Treasury and Administration officials. To arbitrarily limit alternative forms of private participation constitutes a disincentive for lender participation in the 503 program. If this occurs, the overriding objective of the 503 program, stimulation of investment, will be frustrated.

In recognition of the importance of IDBs to the small business sector and the high transaction costs traditionally associated with smaller issues, the ~~1973~~ 1983 Oregon legislature overwhelmingly passed legislation authorizing "umbrella" or composite IDB issuance.

This program provides:

* funding for projects under $1 million.
* various credit enhancements by the State which makes the bonds broadly marketable, thereby accessing capital sources not previously avalable.
* a program directed at the small business sector,
* the incentive for private capital to leverage the State's participation.

The ability to utilize this authority in combination with the 503 program constitutes the cornerstone of a financial program's effort designed to augment economic development in a state which has historically and continues to be a net importer of capital.

In application, the 503 program, in combination with umbrella bonds, offers small business the opportunity to access the capital markets directly in addition to the traditional local funding sources. Potential sources include:

* Local capital, through participating lending institutions.

* taxable bond market for the SBA portion through the Federal Financing Bank.

* tax exempt bond market through the "Umbrella" bond program.

It is important to stress that income from bonds sold to finance the SBA portion is, in all cases, fully taxable.

Tax-exempt financing only comes into play as an alternative method of funding the private sector participation and in the "Umbrella Bond" approach, comes with an acceptable transaction cost.

Personal experience suggests that reduced cost of financing can be and often is sufficient inducement to motivate investment now, rather than later, because the lower cost of financing leaves a greater cushion of earnings available for working capital to finance ongoing business operations.

Total industrial aid financing for the 9 months ending September, 1983 amounted to $2.6 billion or 4% of total tax exempt debt issues during the same period ($61 + billion). The small business element of this modest total for industrial aid is scarcely significant enough to constitute the "raid" on the U.S. Treasury purported by IDB critics. Rather, use of IDB's in small businesses must be one of the more justifiable applications of this type of financing.

Further, use of IDB's in conjunction with the 503 program appears to have been contemplated by the Congressional Budget Office. Alice Rivlin, Director of CBO testified before the House Ways and Means Oversight Committee in 1981. In part, Ms. Rivlin stated, "In keeping with the intent of the 1968 legislation, the Congress might want to target IRBs toward smaller businesses to facilitate their access to credit or encourage new competition. If so, the Congress could establish criteria for small issue IRB financing that conforms to the guidelines set forth by the Small Business Administration or it could limit the usefulness of IRBs to larger firms by setting limits on the amount of small issue financing that any given firm could use. If the goal is to make credit available to riskier firms, the Congress might want to consider coordinating the use of small issue IRBs with other public programs that offer loans, grants, or guarantees."

Use of IDBs in conjunction with the 503 program constitutes such a coordinated effort, but avoids traditional guarantees through the subordination process. This joint, cooperative effort greatly enhances the attainment of the common goal of both programs, investment -- productivity and economic growth -- jobs.

STATEMENT OF J. A. GARRETT, PRESIDENT, TEXAS CERTIFIED DEVELOPMENT CO., CEDAR PARK, TEX.

Mr. **Garrett**. Thank you, sir, for having us here. This is indeed a unique opportunity for someone from a small town in Texas, to come up and have the privilege to speak concerning something that we think is as important as this issue.

I am with Texas Certified Development Co. We are a statewide—except for the Texas Panhandle—certified development company under the 503 SBA program. We are one of the most active development companies in the United States. This last year we have done between 70 and 80 loans, this fiscal year 1983, and this year we plan to do more—probably twice that amount.

We are working real hard now in the Texas Valley, which is in a state of economic chaos in some areas down there. We already have delivered several loans into that marketplace. The 503 program is a very, very good program; however, it could become an excellent program if coupled with the IRB program.

The Texas Economic Development Commission of the State of Texas, under the direction of the Governor, and following the lead of President Reagan's jobs bill, initiated an umbrella bond program this year; with a maximum amount of $750,000 their criteria are set up to work with the 503.

We, in effect, would be initiating most of the bonds, because in Texas Certified we have about 15 loan consultants in the field taking this program into the marketplace, trying to sell it to the small business concerns, to make them aware of it. They don't know it exists.

I think we had six or seven loan packages that got through before September 30. We would like to have the privilege of submitting everything we turn in that would qualify through this program.

I was amazed at some of the things that the gentleman from the Department of the Treasury had to say. He was speaking against small businesses, as I heard it, and that's really amazing since they are the backbone of this country. Most of the jobs, most of the money, most of the taxes, everything comes from small business according to the information that we have. And yet they are attempting to restrict the capability of these small business concerns to expand, to grow.

Also, he talked about the double guarantee or the instruments duplicating each other. I agree with the gentleman from Oregon that that just isn't true.

Instead of working capital or accounts receivable types of financing, we are talking about fixed-asset financing.

Let's assume the worst situation, that the small business concern did fail. And let's assume that even after that the SBA did have to come in, and to protect their position they bought out, if you will, the bondholder. They still have fixed assets there, and probably would receive no loss, anyway.

Thank you very much.

Senator **Packwood**. Thank you. Mr. Orr.

[Mr. Garrett's prepared statement follows:]

TEXAS CERTIFIED DEVELOPMENT COMPANY, INC.

October 28, 1983

FINANCE COMMITTEE HEARINGS
S.499

Small business is the heart and soul of America and the backbone of our economy. Yet, very little, if anything, is done to help. As Senator Bentsen has repeatedly pointed out in speeches and articles, most tax bills don't favor small business, most financing programs don't favor small business, and high interest rates are killing small business (over 65,000 last year.)

When I first got involved with the 503 Program, I heard a story about how the 503 Program got its start. It seems an American Congressman was visiting with his Japanese counterpart and was asking how the Japanese Government was able to so effectively help their small businesses and to get so much in return for the money they spent. The response was, "We spend all of our money helping the successful small business become more successful. The companies that can repay the low interest, long-term loans will be in business year after year creating more jobs, more products, more new products and more revenue for taxes." I don't know if the story is true, but it is a good story.

The SBA 503 Program was born. This program is a good program, one of the few that helps the small businessman. They can own their land and building for the first time or they can expand to maintain their place in the market. In Texas, banks would only make 3 to 5 year loans -- maybe 7 years -- at some interest rate above prime and floating. But with the 503 program, we are seeing 10 year and 15 year loans -- a monthly payment a small business can realisticaly afford to pay.

The statements made by the Senator from New York on the Senate floor in February concerning the 503 Program and the IRB Program are statements that I have found to be true in the market in Texas.

OFFICERS
President
J. A. "BUD" Garrett
Vice President
Lloyd Johnson
Treasurer
Whitney Walsh C.P.A.
Secretary
Rochelle King
Legal
William M. Cook

P.O. Box 1613 Cedar Park, Texas 78613 (512) 258-8312

TEXAS CERTIFIED DEVELOPMENT COMPANY, INC.

Fiance Committee Hearings
October 28, 1983
Page 2

Gentlemen, if we are to have IRBs, they should be available to the small business concern and available in conjunction with the 503 Program. Why? To give our small businessman the lowest monthly payment for his fixed asset financing we possibly can.

In response to the Administration Jobs Bill, the State of Texas developed an Umbrella IRB Program primarily to work hand in hand with the 503 Program. The small businesses we were able to get qualified prior to the September 30 deadline were very happy people. Their annual savings using a combination IRB/503 package as opposed to a regular 503 package was approximately $18 to $20 per $1000 borrowed. Our goal at TCDC is to help the small business concern as much as we can through economic development by using all of the tools available.

One of the tools that should be available and can be available is the IRB/503 combination loan.

1. If we have IRBs, they should be for small business.

2. The SBA 503 Program is a good program, the best in the marketplace, but it could become more excellent with the IRB.

OFFICERS
President
J. A. "BUD" Garrett
Vice President
Lloyd Johnson
Treasurer
Whitney Walsh C.P.A.
Secretary
Rochelle King
Legal
William M. Cook

P.O. Box 1613 Cedar Park, Texas 78613 (512) 258-8312

STATEMENT OF MARTIN ORR, SENIOR VICE PRESIDENT, KANSAS CITY CORPORATION FOR INDUSTRIAL DEVELOPMENT, KANSAS CITY, MO.

Mr. ORR. Thank you, Senator. Good morning.

My name is Martin Orr. I am with the Kansas City Corporation for Industrial Development. We are a not-for-profit private corporation sponsored by the city of Kansas City, Mo., the Chamber of Commerce of Greater Kansas City, and the Civic Council of Greater Kansas City. We are an umbrella organization that administers a variety of public authorities and private development activities, including an SBA 503 development company.

Our fiscal year ended August 31, and this past year we participated in over $200 million of financing for the retention and expansion of business in Kansas City.

Kansas City has only one Fortune 500 company. Over 90 percent of our companies are small businesses. And as Mr. Garrett mentioned, small businesses are crucial to the survival of Kansas City and of the Nation. They are so important for our jobs and for absorbing the losses from many of the larger manufacturing companies that are reducing employment in our community as well as in the United States.

Right now we feel that the Small Business Administration's 503 program is an extremely important tool for the expansion of these small businesses we work with. The ability to match this program with industrial revenue bonds is very, very important in allowing small businesses to compete financially on an equitable basis with larger corporations. Large rated companies are able to get 100 percent financing at 60 to 80 percent of prime.

Right now we are working with a large variety of companies that are medium in size, where they are not able to get 100-percent industrial revenue bond financing. Banks and private lending institutions will talk to them in terms of industrial revenue bonds for 50 to 70 percent of a project's costs. Lending institutions tell the companies that they have to come up with 20- or 30-percent equity on a very low-risk, fixed-asset deal. Many of our clients are good solid companies with 5 to 10 years' track record. They cannot compete in the free market unless they can compete equitably with the larger companies relative to plant and equipment financing. And this we feel is an extremely important issue as it relates to combining SBA 503 and industrial revenue bond financing for small businesses.

Industrial revenue bonds as an issue is a broad issue, that I don't want to deal with in general. But I do feel very strongly that as legislation is being considered in Washington, whether it is Senate bill 499 or some of these other pieces of legislation, that special consideration be given to small businesses.

Thank you.

[Mr. Orr's prepared statement follows:]

Statement of

J. MARTIN ORR
Senior Vice President
Kansas City Corporation for Industrial Development
Kansas City, Missouri

and

Vice President/Secretary
National Association of Development Companies

Submitted to

Subcommittee on Taxation and Debt Consolidation
of the Finance Committee
United States Senate

Good morning, I appreciate having the opportunity to be with you. My name is Martin Orr. I am the Senior Vice President of the Kansas City Corporation for Industrial Development (KCCID). The KCCID is a private not-for-profit corporation established by the City of Kansas City, Missouri, the Chamber of Commerce of GKC, and the Civic Council of GKC. As a public/private partnership, we administer a variety of public authorities and private development organizations. These include: the Port Authority of Kansas City, the Industrial Development Authority, the Planned Industrial Expansion Authority, the KCCID-Charitable Fund, the Kansas City Industrial Foundation, and our KCCID/SBA 503 and 502 small business financing programs. During our past fiscal year, which ended August 31, we participated in over $200 million dollars of financing for retention and expansion of business in Kansas City.

Kansas City has only one Fortune 500 Company. Over 90 percent of our companies are small businesses. The success and growth of small businesses in Kansas City and the Nation is crucial to the survival of our free enterprise economy. Although you have heard the reasons before, I want to re-emphasize those I think are most important.

Small businesses by virtue of their size and flexibility are product and process inovators. As they are responsive to market changes, they often have excellent growth trends. As the United States has exported so much of its manufacturing activity, small businesses are increasingly becoming an important factor in specialty manufacturing. For these reasons, small businesses are the major source for creation of new jobs and new taxes--for us in Kansas City and for the Nation.

Because of the importance of small business, we were founding members of the National Association of Development Companies. We want to do as much as possible to insure success of the Small Business Administration's 503 debenture financing program. More importantly, we want to insure that the SBA 503 program becomes an even better tool for fixed asset financing by small businesses.

Senate Bill 499 is an excellent and simple piece of legislation. Bottom line--it allows SBA 503 debentures to be subordinated to tax exempt industrial revenue bonds. I do not want to debate the issue of industrial revenue bonds in general. I want to emphasize the importance of providing equity to small businesses.

Small businesses need and deserve the opportunity to make fixed asset investments at costs comparable to that of large corporations. Although significant efforts are being made to curtail the use of tax exempt financing--it is apparent that some form and degree of tax exempt financing will continue. If anything, the efforts underway will make credit requirements even more difficult for small businesses.

The SBA 503 debenture financing program is predicated on two facts. There are viable growing small businesses that need help with financing for fixed asset growth. And secondly, the combination of 50 percent first mortgage private financing with 40 percent second mortgage SBA 503 debenture financing, requires that the small business invest only 10 percent of the total project costs. The small business is able to protect as much available cash as possible to meet working capital needs which will increase as the company grows.

While larger businesses have access to 100 percent financing at 60 to 80 percent of prime--creditworthy small businesses find that this source of financing is either not available, or available for only a portion of project costs at a higher rate and shorter term. Those small businesses with so much potential to create a maximum return for a small tax incentive find that they cannot participate.

The ability of local development companies to match SBA 503 debenture financing and tax exempt industrial revenue bond financing should be considered in terms of short and long range benefits to both local communities and the national government. A tax exempt first mortgage versus a prime plus conventional first mortgage will add to the positive cash flow of a small business. The savings in cost of fixed asset financing will result in greater profits, and more business income taxes, locally and nationally. The improved cash flow will allow the small business to effectively manage its funds for continued growth--growth in employment and taxes.

Senate Bill 499 may have an added benefit to the U.S. Treasury. Financial institutions now buying tax exempt bonds for 100 percent of a project's costs will be able to finance their small business clients with only 50 percent tax exempt, and offer the long term benefits of SBA 503 debentures.

In summary, I encourage your support for Senate Bill 499. I believe the benefits to our small businesses--the opportunities for increased employment--and increases in local and national earnings' taxes--far offset the concerns of those opposed to tax exempt financing in general. Furthermore, I ask that you give special consideration of small businesses, in any legislation pursued to curtail tax exempt industrial revenue bonds.

Thank you very much for allowing me to testify this morning. Your consideration is greatly appreciated.

Senator PACKWOOD. I would add just one word of caution on industrial revenue bonds. You are all aware of the occasional abuses of them, and one day the baby may get thrown out with the bath water if those who legitimately use them cannot band together to help us cure the abuses.

I can see it coming down the road. I hate to see a good program lost because some of your peers will permit the abuse and do nothing to stop it. You would all, therefore, get penalized.

Mr. ORR. I agree. I have been involved in industrial development for 14 years, and originally I thought of myself as strictly an industrial development professional. Now I am referred to as an economic development professional, and they expect us to do everything from shopping centers to manufacturing plants. And I think industrial revenue bonds have gone the same way. They used to be strictly manufacturing and industrial-type uses, and now massage parlors and who knows what else.

Senator PACKWOOD. Well, let's not speculate. [Laughter.]

Mr. Garrett, you look like you are about to say something.

Mr. GARRETT. Yes.

One of the things I intended to say a few moments ago is that we certainly agree with the Congressman and the Senator who spoke previously on behalf of this bill. They outlined many of the benefits that, of course, we could have done; but we decided to talk of what is going on in our areas.

But we have a program down there that can really deliver low-interest rate money to a small business concern that is not really giving them an advantage above anyone else; it's just making them equal to their larger competitors. And they need this advantage.

Senator PACKWOOD. I agree.

Gentlemen, thank you very much for coming today.

Mr. CLEMENTS. Thank you, Senator.

Senator PACKWOOD. Now we will move on to a panel of Mr. Leo Baldwin and Ken Scholen, both on S. 831 and S. 1914.

I see Senator Boren is here. David, would you like to comment on your bill before the panel starts?

Senator BOREN. I have already put my statement in the record on the remarks of the past panel, so I won't interrupt to add further. But I agree with the statements that you have made about the importance of providing investment capital at reasonably competitive rates for small businesses, because it is really their lifeblood.

I want to again commend you for having these hearings. A strong interest has already been expressed in the Small Business Committee in this particular piece of legislation, and I'm very pleased to join with you in expressing interest in it and support for it.

Senator PACKWOOD. Yes. We had some very good testimony on revenue estimates, because the Treasury has what appear to be unrealistic estimates of revenue losses.

Senator BOREN. Well, they appear unreasonable to me as well, and I hope we can straighten that out, because I think we simply must be sensitive to capital costs. More and more experts from several different areas have been coming to us as individual members of the committee, pointing out that the cost of capital becomes absolutely crucial in terms of the ability of enterprises to compete. And this is particularly true of our smaller enterprises.

I think it is extremely important that we take action in this area. And I hope that the objections of the Treasury can be resolved so that we can move forward with this legislation.

Senator PACKWOOD. Thank you.

Mr. Baldwin.

STATEMENT OF LEO BALDWIN, HOUSING COORDINATOR, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, D.C.

Mr. BALDWIN. I am Leo Baldwin, coordinator for housing programs for the American Association of Retired Persons. We are here to testify regarding S. 831 and S. 1914.

These bills are designed to facilitate home equity conversion through sale-leaseback transactions.

The interest of the association is to make available to its members and the older population at large legitimate alternatives by which assets such as home equity may be used with responsibility and prudence during the remainder of their lives, as discretionary cash resources.

We believe that it is crucial that Federal and State legislation provide minimum standards for sale-leaseback transactions. These should include: First, the control of the tenure of the lease by the seller-tenant; second, resale of the property only if the new buyer-landlord accepts existing contractural obligations between the original parties; third, rent increases over the life of the lease determined by reference to a defined, fixed limitation that is reasonable in light of the terms of the sale-leaseback agreement; and fourth, adequate protection against an artificially low discount sales price.

Unless it is clearly understood that social goals are to be served in conjunction with financial interests, AARP would take the position that this legislation is poor public policy.

AARP recognizes that, as an irreversible lifetime decision, there are certain risks inherent in sale-leaseback transactions. For example, the seller will turn the title of the house over to the buyer, which could increase the seller's risk in certain situations, such as the bankruptcy of the buyer.

No one can predict the impact of inflation upon the buying power of the cash generated, as this dollar amount remains fixed for the life of the seller-tenant.

Future appreciation on the property cannot be captured by the seller-tenant. The sale price of the property could be somewhat less than appraised value. Although any balance on the sales contract would be collectible by the estate, sale leaseback removes the home as an asset of the estate.

S. 1914 will permit, with more certainty, the sale-leaseback transactions, with its accompanying economic benefits to both parties—the seller-tenant will be able to remain in his home while still enjoying the proceeds of the sale.

The sale will also shift the risks and burdens of ownership to the buyer, further alleviating the problems of the seller-tenant, while in exchange the buyer will be able to take depreciation on the home.

Further tax consequences are clarified by excluding the value of the seller-tenant occupancy rights and fair market discount sales price from the seller-tenant income, while including the net return on any annuity purchase for the seller-tenant as income when that income is received.

Additionally, the buyer will be able to take advantage of current accelerated depreciation rules for investor-owned housing.

The AARP supports these refined interpretations of the present tax law as a means of making the sale-leaseback area more defined, and thus more attractive.

Senator PACKWOOD. Mr. Baldwin, let me say this.

Mr. BALDWIN. Yes, sir.

Senator PACKWOOD. You don't need to read just exerpts from your statement, because the entire statement will be in the record, and I've had a chance to read it. So if you would emphasize orally what your major points are and the concluding portions of your statement, I would appreciate it.

Mr. BALDWIN. Fine.

In connection with S. 1914, we are concerned about the definition of the occupancy rights, being concerned that if the term continues to be defined as "equal" or "exceeds one half of the life expectancy of the seller-lessee," this term may initially be set at too long a period of time, based on the age of the seller-leasor, and they could be locked into a long-term lease which shortly would become an unaffordable burden.

The fair-rental clause is also an integral part of this legislation; but we feel the definition does not go far enough, in that it should be addressed to meet the need for future rent constraints.

Senator PACKWOOD. Mr. Baldwin, I would ask you to conclude your statement. I have read your statement, and you are reading from it. Frankly, I don't need you to read it to me. It will be in the record.

Mr. BALDWIN. Sir, there were those few points in connection with the definition of the terms of the legislation which I wanted to bring to your attention.

I think the one other area that I would emphasize at this point is that we believe that S. 1914 is a positive step toward the viability of home equity conversion through the sale-leaseback transactions.

We would be pleased to work with the committee in the further refinement of that legislation.

Thank you.

Senator PACKWOOD. Thank you.

Mr. Scholen. Do I pronounce that correctly?

Mr. SCHOLEN. Yes.

[Mr. Baldwin's prepared statement follows:]

STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

before the

SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

on

S. 831 and S. 1914, The Home Equity
Conversions Acts of 1983

October 28, 1983

The AARP appreciates the opportunity to testify regarding S. 831 and S. 1914, bills designed to facilitate home equity conversion through sale-leaseback transactions. The Association has a vital interest in reverse equity as the elderly represent a substantial portion of the homeowners whose property is being considered the subject for reverse equity programs. The interest of the Association is to make available to its members and the older population at large legitimate alternatives by which assets such as home equity may be used with responsibility and prudence during the remainder of their lives as discretionary cash resources.

There is little question that a sale-leaseback runs counter to the long held aspiration of many older Americans to own their home and pass it on to their heirs. These seem to be two major psychological barriers. It is not our purpose to encourage or abandon these goals. However, in my discussions with older homeowners and their children, it is clear that there is a growing awareness by both generations that home equity is a legitimate asset which the owner should consider as a means of perpetuating independence and financial stability. How quickly this attitude becomes prevalent we believe, depends upon:

1) the quality of the homeowner protections made mandatory for sale-leaseback transactions which would qualify for tax benefits, and
2) the economic circumstances of the older homeowners as the national economy and public policy limit resources devoted to the needs of this rapidly expanding population.

We believe it is crucial that federal and state legislation provide minimum standards for sale-leaseback transactions.

These should include:

- a) the control of the tenure of the lease by the seller-tenant;
- b) resale of the property only if the new buyer-landlord accepts existing contractual obligations between the original parties;
- c) rent increases over the life of the lease determined by reference to a defined fixed limitation that is reasonable in light of the terms of the sale-leaseback agreement; and
- d) adequate protection against an artificially low discount sales price.

Our testimony is directed to reflect the interest of AARP's membership in the program developed by this bill, the way in which this legislation may be most advantageous to the older homeowner, and the areas in which we believe consumer safeguards need to be provided.

Records of the nature of the experience of older persons with sale-leaseback transactions are very limited. Most such arrangements we believe have been sales within the family or with buyers who were sympathetic to the needs of the older homeowner. Such transactions have often reflected the use of sale-leaseback as a way to tap the "means of last resort" with little or no consideration being given to profit or tax consequences. Among the potential buyers with whom Association staff members have discussed sale-leaseback in the last year or two, it is obvious they have become aware that there are tax consequences and that in addition to the boost it gives a relative or friend, buyers are seeking to improve their own economic circumstances. For the potential seller-tenant there is considerable frustration displayed that legislators and tax authorities have thwarted their efforts to use home equity by not developing concise guidelines under which sale-leasebacks can be consummated.

The sale-leaseback transaction has been well known and used in the manipulation of commercial real estate and certain depreciable durable goods for a long time. The purpose is quite straightforward. That is to divest one party of ownership while maintaining use; to transfer certain capital gains while retaining the income derived; and to do this to the mutual advantage of the contracting parties.

Most of us would have little concern about consumer protection in sale-leasebacks which involve business entities because we can assume the two parties have the knowledge, sophistication and expertise to analyze and negotiate the transaction in their own interest. In addition, there is a body of security regulations and tax laws against which commercial sale-leaseback arrangements can be tested.

However, in the area under consideration today, a number of critical factors are different. First, there is little experience in which private, profit-motivated interests have engaged in the acquisition of private residential property for long-term investment. Second, security commissions and the tax laws are not sufficiently clear. Third, the two parties do not approach the transaction with comparable knowledge, sophistication or expertise. Fourth, the transaction may be conducted in an atmosphere in which the seller-tenant is under some financial pressure due to a waning income and extraordinary expenses. Further, the consumer in this situation is dealing with his most precious asset -- his home -- the potential loss of which without adequate compensation could be devastating. The Association is thus convinced that seller-tenant protection is the primary objective against which this bill must be measured. Unless it is clearly understood that social goals are to be served in conjunction with financial interests, AARP would take the position this legislation is poor public policy.

Although our statements should not be interpreted to indicate that older people are incapable of overseeing their assets, including the equity in their homes, we believe there is a significant number who are vulnerable to high pressure sales tactics, sharp dealing, or the promise of benefits which cannot be fulfilled. Since the market for sale-leaseback arrangements will inevitably involve profit motivated investors and unsophisticated homeowners, we believe it likely that some homeowners may act without due consideration of other alternatives or act without full knowledge of the impact of the transaction upon their lives and living arrangements.

AARP recognizes that as an irreversible lifetime decision, there are certain risks inherent in sale-leaseback transactions.

For example:

1) The seller will turn the title to the house over to the buyer, which could increase the seller's risk in certain situations -- such as the bankruptcy of the buyer.
2) No one can predict the impact of inflation upon the buying power of the cash generated, as this dollar amount remains fixed for the life of the seller-tenant.
3) Future appreciation on the property cannot be captured by the seller-tenant.
4) The sale price of the property could be somewhat less than appraised value. This is necessary to attract a buyer who is giving up certain rights, such as occupancy rights, normally obtained in the acquisition of property.
5) Although any balance due on the sales contract would be collectible by the estate, sale-leaseback removes the home as an asset of the estate.

Despite its limitations, it is apparent that sale-leaseback is of interest to a substantial number of older homeowners. Questions raised by interested homeowners are generally related to the following issues:

1) Is such an opportunity available in my community;
2) Where do I go for information/advice;
3) How can I be assured of the right to live in my home;
4) How can I be assured of an adequate flow of cash throughout my life;
5) How does this affect my estate;
6) How will this affect my tax situation; and

7) What will happen if the buyer gets into financial difficulties.

S. 1914 clarifies the answers to many of these questions. The legislation will permit with more certainty the sale-leaseback transaction with its accompanying economic benefits to both parties. The seller-tenant will be able to remain in his home while still enjoying the proceeds of the sale. Since the seller-tenant must be 55 or over, he would qualify for the one-time Section 121 capital gains exclusion, thus making the transaction more attractive and beneficial. The sale will also shift the risks and burdens of ownership to the buyer, further alleviating the problems for the seller-tenant, while in exchange the buyer will be able to take depreciation on the home. Further tax consequences are clarified by excluding the value of seller-tenant occupancy rights and fair market discount sales price from the seller-tenant's income, while including the net return on any annuity purchased for the seller-tenant as income when that income is received. Additionally, the buyer will be able to take advantage of current accelerated depreciation rules for investor-owned housing. AARP supports these refined interpretations of present tax law as a means of making the sale-leaseback area more defined and thus more attractive.

AARP also supports the definition of occupancy rights. As an essential feature of this legislation, the seller-tenant is guaranteed the right to remain in his home by exercising a continuing right of renewal of the lease until his death. This will help insure that the seller-tenant retains the one critical option in this transaction, the right to choose to live in one's own home for the remainder of one's lifetime. This option will retain its effectiveness only if upon resale of the property the new buyer is also obligated to assume all responsibilities in the existing contract.

One change in S. 1914 may be needed in the definition of "occupancy rights." The bill states in part that the right to occupy would be for a term that "equals or exceeds one half of the life expectancy of the seller-lessee." This term may initially be set at too long a period of time. The seller-tenant may be locked into a long-term lease which shortly becomes an unaffordable burden. Since the bill already provides for a continuing right of renewal, a shorter original term may be more appropriate.

The "fair rental" clause is also an integral part of this legislation, but the definition does not go far enough. The bill fails to address the need for future rent constraints. A modification is needed to expand the meaning of "fair rental" by addressing the extent to which future increases in an initial market rent can be limited without jeopardizing the validity of the sale or creating imputed gain or loss. This can be accomplished by legislating that future rent increases must be defined by a reasonable limitation set out in the contract of sale. The limitation itself need not be specifically defined in the legislation, but may be left to the contracting parties to use such options as indexing to an acceptable economic indicator or payment agent. This will allow the parties to choose the option most appropriate in view of life expectancy, the discount on the sales price or other contingency in each transaction. More importantly, this provision will provide some protection for the seller-tenant against future prohibitive rent increases.

We feel the most effective protection would be an indexing related to the future income of the seller-tenant, a good example being the social security cost of living adjustment. If future rent increases cannot be reasonably restrained, the seller-tenant may in practice be effectively precluded from exercising the renewal option mandated by this legislation. This would be contrary to the social goal which AARP believes this legislation must protect -- the opportunity to live in one's home for the remainder of one's lifetime. By requiring a reasonable limitation in the rent increase in the contract of sale, the seller-tenant can be adequately protected from exhorbitant future rent increases that would drive the seller-tenant from his home.

Another area of concern for the Association is the size of the discount of the purchase price of the home. The Association feels that the discount sales price should be appropriately related to the fair market value of the home taking into account all the terms of the lease and the individual contracting parties. This could be accomplished by giving the IRS the authority to investigate whether the transaction was conducted on an arm's length basis. This would serve to ensure fair dealing between the parties, thus protecting the seller-tenant from receiving a disproportionately low sales price with respect to other contract terms.

There are other features of sale-leaseback transactions, while perhaps more appropriate for regulation outside of a tax bill, which should be brought out to this subcommittee upon consideration of this legislation. First, in order to ensure better protection for the seller-tenant, a full disclosure of information will be necessary, including all the obligations, options and risks inherent in these transactions. Only with full knowledge will the seller-tenant be able to make an intelligent and informed decision with respect to home equity conversions. Second, to help prevent pressure tactics by profit-motivated buyers from causing a seller to make an ill-advised sale, a rescission period should accompany each sale-leaseback transaction. This extra time may be necessary to enable the seller to reconsider the transfer of an asset as precious as one's home.

A further protection that should become an industry standard would require that the buyer purchase an annuity for the seller that would become payable when the monthly payments on the sales contract cease. The cost of the annuity, purchased by the buyer for the seller-tenant, would be included in the purchase price. The guaranteed flow of income would best serve to ensure the elderly beneficiary of lifetime security.

The Association believes that the design of S. 1914 is a positive step towards the viability of home equity conversions through sale-leaseback transactions. We support the present attempt to redefine acceptable limits of already existing tax treatment. In order to become a meaningful aid to the elderly homeowners who live on modest fixed incomes, legislation in this area must further ensure the quality of homeowner protection. AARP hopes to be able to continue to work with the subcommittee in support of its efforts to enact legislation that would open up the area of equity conversion for homeowners.

STATEMENT OF KEN SCHOLEN, DIRECTOR, NATIONAL CENTER FOR HOME EQUITY CONVERSION, MADISON, WIS.

Mr. SCHOLEN. Thank you, Senator. I will summarize my prepared comments.

The earlier oral testimony by the Treasury Department may give the impression that S. 1914 creates a new class of tax shelter for investors. This is simply not the case. Based on existing case law, existing revenue rulings, and explicit Treasury Department testimony to the Senate, it is abundantly clear that in a residential sale leaseback the seller may already take the one-time capital gains exclusion if otherwise qualified, and the buyer may already take deductions for depreciation and expenses.

What is not clear in the law, however, is really the heart of the matter and the key element of the sale-leaseback transaction, namely, the degree to which the future occupancy rights of the seller may be safeguarded without jeopardizing the tax status of the transaction.

At one extreme, it is clear that short-term occupancy rights—for example, a 1-year lease with no limit on future rent increases—would be permissible. At the other extreme, it is clear that a rent-free life estate would not be permissible.

Ironically, the tax status of the sale leaseback becomes increasingly questionable as the occupancy rights of the seller become more secure. The lack of legal clarity in this area means, therefore, that parties to current sale-leaseback transactions have an incentive to "play it safe" from a tax perspective at the cost of reducing the security of the seller's occupancy rights. This perverse incentive undermines the fundamental purpose of the transaction. That is the central issue in S. 1914: to clarify the extent to which occupancy rights may be safeguarded.

Changes in this legislation responding to the concerns of the Treasury Department are discussed in my written statement. In short, the statutory definition of "fair rental" should not specify a below-market rent, although future rent consultants should be permitted. In addition, the section regarding the valuation of occupancy rights should be subject to a condition that the purchase price be reasonably related to full fair-market value unencumbered by the lease but taking into account the condition of the leaseback and the terms of the lease.

Thank you.

[Mr. Scholen's prepared statement follows:]

Statement on S. 1914
to the
Senate Finance Subcommittee on Taxation & Debt Management
by
Ken Scholen, Director, National Center for Home
Equity Conversion

October 28, 1983

America's fast-growing elderly population could be more self-sufficient and independent if older Americans could more fully use the most important financial asset they already own. At present, most older persons do not derive any cash income from their single largest financial investment.

Most older Americans own a mortgage-free home. The overwhelming majority prefer to live independently in their own homes for as long as they can. Because they don't sell and move, however, most older homeowners never turn this frozen resource into cash.

Converting home equity into income for the elderly while they remain in their homes is the purpose of various home equity conversion mechanisms now being developed and tested throughout the country.

In one of these plans - the residential sale leaseback - a homeowner sells her home but remains living in it as a renter.

Based on case law, revenue rulings, and explicit Treasury Department testimony, it is clear that in this type of transaction the seller may take the one-time capital gains exclusion if otherwise qualified, and the buyer may take deductions for depreciation and expenses.

What is not clear, however, is really the heart of the matter and the key element of the deal: namely, to what degree may the future occupancy rights of the seller be safeguarded without jeopardizing the tax status of the transaction?

At one extreme, it is clear that short-term occupancy rights, for example, a one-year lease with no limit on future rent increases, would be permissible. At the other extreme, it is clear that a rent-free life estate would not be.

The tax status of the deal becomes increasingly questionable as the occupancy rights of the seller become more secure. The lack of legal clarity in this area means, therefore, that parties to current sale leaseback transactions have an incentive to "play it safe" from a tax perspective at the cost of reducing the security of the seller's occupancy rights. This perverse incentive undermines the fundamental purpose of the transaction.

That is the central issue in S. 1914. It is the reason we need legislation or an administrative ruling to clarify the extent to which occupancy rights may be safeguarded. Such clarifying legislation should as nearly as possible reflect existing tax code provisions, case law, and revenue rulings.

In particular, S. 1914 should be amended in the following respects:

1) the bill should be re-cast as "safe harbor" legislation, i.e., its compliance criteria should not be exclusive, and any failed attempt to meet such criteria should explicitly not create a presumption against compliance;
2) the statutory definition of "fair rental" should not specify a percentage of appraised fair market rent, but should permit the parties to constrain future increases in a current fair rental, provided such constraints do not arbitrarily decrease the initial fair rental; and
3) provisions regarding the value of occupancy rights or fair market price discount should be subject to the condition that the purchase price be reasonably related to full fair market value unencumbered by the lease, but taking into account the condition of the leaseback and the terms of the lease.

(Further discussion of these issues and recommendations are included in an attached supplementary statement prepared originally for the Federal Council on the Aging.)

Clarifying federal tax policy on residential sale leasebacks is one step toward unlocking the largest single source of private savings held by older Americans. Converting home equity into income provides a new way for older homeowners to purchase the goods and services they need to remain independent.

THE ISSUE IS SAFEGUARDING THE SELLER

Supplemental Statement for the Federal Council on the Aging
by Ken Scholen, Director
National Center for Home Equity Conversion
September 27, 1983

At present, a seller and buyer of residential property[1] can transact a sale leaseback and receive all of the basic tax benefits necessary to make such a deal work.[2] Then why are legislation and/or administrative rulings needed? They are needed because

1) only those sale leaseback deals with a certain combination of terms and characteristics clearly qualify for the tax benefits;

2) the deals that clearly do qualify are the ones that do the worst job of safeguarding the elderly seller;

3) the deals that clearly do not qualify are the ones that do the best job of safeguarding the elderly seller;

4) between these two extremes there is a hazy middle ground of legal uncertainty; and

5) elderly sellers need to know how far they can go in safeguarding their legitimate interests without jeopardizing the tax status of the transaction.

The most direct way to analyze this issue is to consider A) the deals now clearly favored by the tax code; B) why these deals are dangerous for the elderly seller; C) how these deals could be made safer; D) the tax implications of safeguarding the seller; E) the uncertainties these tax implications create; and F) how elderly sellers can gain a reasonable measure of statutory and/or administrative guidance in safeguarding their legitimate interests within the boundaries of a responsible transaction and sound tax policy.

A) Currently Favored Transactions

At present, favorable tax treatment is given to residential sale leasebacks that most closely match the terms and characteristics "formula" in the following transaction: a) the home sells for fair market value; b) title transfers to the buyer and the seller retains no repurchase option; c) the buyer is responsible for all taxes, special assessments, major maintenance, and repairs; d) the buyer is entitled to all future appreciation in the home's value and any condemnation awards or other insurance proceeds; e) the buyer bears the risk of loss from depreciation, casualty, and condemnation; f) the seller pays a fair rental on an annual lease with no limits on future rent increases; g) the interest rate on seller financing is reasonable; h) the deal is entered into for profit by the buyer; and i) neither party enters into the deal for tax avoidance purposes.

At present, this type of sale leaseback qualifies for the following tax treatments: a) the seller may take the one-time capital gains exclusion on the sale of a principal residence if otherwise qualified; and b) the buyer may take deductions for depreciation, property taxes, insurance, maintenance, and improvements.

B) Risk for the Seller

The "formula" sale leaseback outlined above today qualifies for the tax benefits that make the deal work. No legislation or administrative ruling are necessary. So why aren't sale leasebacks structured according to this formula? What's wrong with this deal?

The problem is that one part of the deal is much too risky for most elderly sellers. Indeed, it is so dangerous that an elderly seller would be ill-advised to enter a contract having this provision.

This excessively risky feature is the absolute right of the buyer to raise the rent without limitation throughout the life of the seller's tenancy. The danger is that rapidly escalating rents can quickly eat up the seller's new monthly income from the deal. This in turn can make the home much too costly to rent (unless, of course, the seller has substantial income or assets other than the home). Although the seller may retain a legal right to lease the home on an annually renewable basis, she may no longer be able to afford it.

The rent increase issue is pivotal in protecting the integrity of the transaction and in safeguarding the seller's vital interests. A seller's motivation for entering the deal is to increase spendable income while maintaining a reasonably secure right to remain in the home as a renter. With unlimited future rent increases, however, the sale leaseback can end up impoverishing older persons and forcing them from their homes.

C) Reducing the Risk

The seller who wants to ensure the tax status of the transaction will agree to pay a market rate of rent at the outset of the deal. But the seller who wants to safeguard her future financial and occupancy interests will also have a legitimate interest in obtaining some contractual assurance about future rent increases.

This rental safeguard could take the form of a perpetually fixed rent, a fixed schedule of annual rent increases, a clause permitting annual increases tied to an index but not exceeding a given percentage, or any of a variety of combinations of these or other possibilities.

As the safeguard mechanism becomes more favorable to the seller, however, the property becomes less valuable to the buyer. As a result, the buyer is willing to pay less for a more stringently encumbered property.

This dynamic is magnified by the life expectancy of the seller. The younger the seller, the longer the rent safeguard is likely to be in effect and, therefore, the less a buyer would be willing to pay for the property. In the case of a very old seller, by contrast, the buyer would be less concerned about a given rent safeguard because it could not be expected to be in force as long.

From a seller's standpoint, the difference between two rent safeguard provisions can end up being much greater than they may initially appear to be. For example, with an annual rent escalator of 2% it would take over 20 years for the monthly rent to increase by 50% over the amount charged in the first year. But with a 7% annual escalator, the rent would reach that same level in only 6 years; it would double in 11 years; and it would quadruple in the time it took the 2% escalator to reach a 50% increase.

D) Jeopardizing the Tax Benefits

Safeguarding the seller against unlimited rent increases jeopardizes the tax benefits of a sale leaseback. It does so because it introduces two related deviations from the formula transaction outlined earlier in part A.

First, it places an explicit contractual limit on future rent increases. This means that at some future time the actual rent paid by the seller may be less than what would have been paid without the limit, i.e., less than a future "fair market" rent.

Second, safeguarding the seller against rent increases reduces the value of the property for the buyer. This means that the seller and buyer are likely to negotiate a sales price that is somewhat less than the price would be if the deal did not include a rent safeguard, i.e., less than a "fair market" price.

These related deviations from the tax-favored sale leaseback formula jeopardize the transaction in two respects. First, they may cause the IRS to conclude that a true sale has not occurred and that, therefore, the tax benefits listed in part A are not available to the parties. Second, the IRS may require that some or all of any difference between the negotiated sales price and the "fair market" value of the home when sold without a rent safeguard be reported as prepaid rental income by the buyer, and as imputed gain or loss by the seller.

The degree to which a rent safeguard jeopardizes the tax status of a sale leaseback depends upon the degree to which it protects the seller.[3] At the extremes, the issue is clear-cut. "The closer the transaction comes to unlimited rent increases, the more likelihood there would be a valid sale . . . "[4] and the less likelihood there would be an imputed income/gain requirement. At the other extreme, a rent-free life estate has been ruled to be not a valid sale by the IRS.[5]

The practical, real-life problem is not at the extremes, however. It is knowing to what degree the elderly seller can be safeguarded without jeopardizing the tax status of the deal. This is probably not a serious problem for sellers having substantial income or assets other than the home. But it is the key issue for most sellers who are entering a sale leaseback precisely because they do not have such income or other assets.

E) Uncertainty for the Seller

Where does this leave the elderly seller who wants to transact a valid deal with economic substance, who wants that deal to fall cleanly within the boundaries of federal tax law, who is not motivated by tax avoidance, who is willing to meet the basic "formula" requirements for a clearly tax-favored sale leaseback, and who wants some reasonable rent safeguard that is reflected in the negotiated sales price?

What should this person do? Should she forget about her own best interests, and agree to unlimited future rent increases just to make certain it's a valid sale? In effect, the current uncertainty of federal policy provides an incentive to do just that.

Assuming that she agrees to a first year rent at a market rate, should the seller agree to a fixed future schedule of substantial (i.e., arguably "market") annual rent increases? Such increases would substantially diminish any difference between the negotiated sales price and the home's "market" value. This would mean a larger down payment and/or larger installment purchase payments to the seller from the buyer. But these increased inflows to the seller would be much more rapidly surpassed over time by substantially escalating rental costs than the inflows from a reduced price would be by a more constrained rent schedule.

Assuming the IRS would permit some kind of future rent schedule, what is likely to be deemed reasonable? The difference between a 2%

annual increase and a 7% annual increase, as we have seen, is a difference in degree so great that in time it becomes a difference in kind. Two percent qualifies as a safeguard, but seven percent can become a formula for economic eviction.

In guessing how much of a rental safeguard (and price reduction) the IRS might permit, should the seller take into account her life expectancy? Should she assume that the IRS (like the buyer) is likely to accept a stronger safeguard for a shorter expected term, and a weaker safeguard for a longer expected term? Should both parties assume that any price "reduction" will have to be reasonably related to the value of the rent safeguard? If so, by what method should this be calculated? Should the buyer report the price reduction as imputed rental income? Should the seller take it into account in determining capital gain or loss?

F) Guidance for Safeguarding Sellers

All of these questions arise from a single source: the need to safeguard the seller against unlimited future rent increases. Without this need, the questions would be irrelevant, and there would be no serious legislative or administrative barriers to sale leaseback arrangements.

But because the rent safeguard is central to the integrity of the transaction, elderly sellers need some statutory and/or administrative guidance on this issue. They need to know how far they can go in protecting their interests without jeopardizing the tax status of the transaction.

An IRS revenue procedure could provide this guidance. But, depending upon the specificity and the specific provisions of that guidance, legislative action might still be required. For example, the IRS might rule that an initial market rent plus a fixed schedule of reasonable future rent increases is permissible. But it might not define "reasonable" at all, or it might define "reasonable" as being an annual percentage that exceeds what is in fact workable. In addition, such a ruling may neither speak to nor provide sufficiently clear guidance on the imputed gain or loss issue. Indeed, the IRS may never issue such a ruling of any kind.

It makes sense, therefore, to continue refining new statutory language. This activity will suggest content for an administrative ruling, establish a standard against which such a ruling can be compared, and continue preparation for a legislative solution should the ruling not be forthcoming or sufficient. The basic purpose of this legislation (or any administrative ruling) should be to clarify the meaning of "fair rental" by addressing the extent to which future increases in an initial market rent can be constrained (and the purchase price reduced) without jeopardizing the validity of the sale or creating imputed taxable gain or loss. Presumably, a transaction with some marginal rent constraint and marginal price reduction taken together with the full panoply of "formula" requirements listed in part A (including in particular an initial market rent) would qualify under current law for the tax benefits listed in part A.

Any regulation or ruling, therefore, would not be creating a new "favored class" or "new complexity" in the code. Instead, it would be defining the limits of an already existing tax treatment, and reducing the complexity faced by taxpayers who want to know and abide by those limits. It would not "give" a tax benefit that does not now exist; it would clarify the boundaries beyond which an already existing benefit is not available.

In addressing such a limited goal, legislative or administrative initiatives should not seek to make fundamental code changes with resoect to related but separate issues. They should not create new tax treatments for sale leasebacks that are fundamentally different from the treatment now given to sales in general and to ownership of rental property. Neither should they create new tax treatments for certain types of residential sale leasebacks that are different from treatments now clearly accorded very similar types of residential sale leasebacks.

For example, at present the seller of a principal residence who is 55 years of age or older may on a one-time only basis exclude up to $125,000 of gain. This tax benefit is now clearly available to sellers who move, and to sellers who lease back their home (provided they meet the formula requirements in part A). What is not now clear is how far the seller can go in constraining future rent increases and reducing the purchase price - and still claim the existing exclusion.

Legislation clarifying this matter of limits should not also address a separate issue that has been raised in other testimony, i.e., the distributive impact of the capital gains exclusion itself. It is true that the exclusion is structured as a deduction rather than a credit. It is also true that up to a point the value of this particular structure in general increases with income and home value. These facts are generally known and understood. Nevertheless, this legislation should not attempt to make the capital gains exclusion more progressive for all qualifying sellers in general, or just for all or some leaseback sellers in particular. It should simply clarify the extent to which elderly sellers who lease back their homes can safeguard their interests while remaining eligible for the existing exclusion.

Similarly, the legislation should not attempt to re-assign the basic distribution of tax benefits that normally go to elderly sellers (the capital gains exclusion) and to owners of rental property (depreciation and expenses deductions). It may be, as some have argued, that this arrangement favors the rental owner over the seller. But that major policy issue - like the capital gains matter - is not an appropriate topic for this legislation.

Applying a different kind of capital gains exclusion to sales that involve leasebacks, or to certain types of sale leasebacks, would create a new "favored class" and "new complexity." This would also be the case if a different distribution of tax benefits between elderly sellers and rental property owners were instituted for sales involving leasebacks, or for certain types of sale leasebacks.

On the other hand, neither legislation nor administrative ruling should be so finely prescriptive on the limited issue at hand that it unduly restricts the functioning of this market by arbitrary design or inadvertence. General guidance and direction are what is needed.

Testimony presented to the Federal Council on September 14 strongly suggests that the Specter draft should be amended to reflect the formula characteristics listed in part A as modified by the following four provisions: 1) require a market rate of rent that by contract may be subject to future increases but may not be arbitrarily decreased; 2) permit an annually renewable or lifetime lease; 3) require that the sales price be reasonably related to fair market value taking into account the terms and conditions of the lease; and 4) provide that neither seller nor buyer receive imputed gain, loss, or income based on a sales price derived in this manner.

Considering the Langford and Giberson decisions in particular[6], it is reasonable to conclude that the substance of this amended bill could be issued as a revenue procedure by the IRS. Whether in administrative or legislative form, however, the provisions suggested above address the major relevant issues raised at the FCA hearing. They speak directly to the practical questions that arise from the need to safeguard the legitimate interests of the elderly seller.

Without this type of clarification there will continue to be only three types of residential sale leaseback transactions:

1) deals without rent safeguards made by wealthy individuals who can afford the financial risk;

2) deals without rent safeguards made by non-wealthy persons who cannot afford the financial risk, but who nonetheless take it to avoid the legal risk that the IRS might subsequently overturn the agreement; and

3) deals with rent safeguards that run the risk of IRS disapproval (if investors for such deals can be found).

We need to move beyond this unacceptable trio of choices. That is the only way elderly sellers can be safeguarded against unreasonable rent increases that threaten their economic and residential security.

Notes

[1] The tax advantages and business purposes of residential sale leasebacks are significantly different from those of commercial sale leasebacks. A summary of the tax and business features of commercial sale leasebacks is discussed by Del Cotto, 37 Tax Law Review 1981, pp. 3-6. Two Tax Court decisions on residential sale leasebacks are cited in note 6 below.

[2] Letter submitted to Senator John Heinz by John E. Chapoton, Assistant Secretary for Tax Policy, U.S. Department of the Treasury, on August 20, 1982.

[3] Tax benefits triggered by a sale of property are not permitted unless a valid sale has taken place. If the "seller" retains substantial occupancy rights and control of the property, then the IRS may rule that for tax purposes a valid sale has not occurred. But the seller in a sale leaseback needs some assurance that her future occupancy rights as a renter are secure. Yet she must be careful that they are not so secure (e.g., a rent-free life estate) that she remains the owner in the eyes of the IRS. The formula transaction in part A describes a clearly valid sale. This transaction, however, does not have sufficiently secure future occupancy rights for most elderly leaseback sellers. As progressively stronger future occupancy rights are introduced into the deal, moreover, the validity of the sale becomes increasingly questionable.

[4] Statement submitted to the Federal Council on the Aging by Nancy Schurtz, Associate Professor, University of Oregon School of Law, on September 14.

[5] Internal Revenue Service Letter Ruling #8029088.

[6] Langford v. Commissioner, 42 TCM 1160 (Dec. 38,270(M), 1981); Giberson v. Commissioner, 44 TCM 154 (Dec. 39,111(M), 1982).

Senator Packwood. Do you think this bill can be made a workable bill, so long as we have those protections in it?

Mr. Scholen. Yes, sir.

Senator Packwood. Mr. Baldwin, do you think so, too?

Mr. Baldwin. We feel the same way. Yes, sir.

Senator Packwood. I think the fears you expressed are justifiable. I can see, without the protections on occupancy, you are going to have the possibility of abuse. I don't want to prejudge anybody, but I can see the possibilities. Clearly, that is the one thing that the seller wants. That's the reason they are selling. They want to have the income and yet some guarantee of a life tenancy.

David.

Senator Boren. No questions, Mr. Chairman.

Senator Packwood. Gentlemen, thank you very much.

Mr. Baldwin. Thank you.

Mr. Scholen. Thank you, sir.

Senator Packwood. We will move on to a panel consisting of Richard Finn and Lana Batts, on S. 1231.

Senator Boren. Mr. Chairman, I wonder if I might make an opening statement on this as one of the cosponsors of the legislation, before we have the very able panel present their statements?

Senator Packwood. By all means.

Senator Boren. I will summarize and ask that my full statement appear in the record.

Mr. Chairman, you remember that back in December, in the closing ~~hours of the~~ debate on the Surface Transportation Act of 1982, that I and others became aware of a gross inequity that exempted from the 12-percent Federal sales tax a rail vehicle known as the RoadRailer to the exclusion of a vehicle made and used for the same purpose, a piggyback trailer.

This was discussed on the floor, in fact, in a colloquoy at the time that the bill was passed. As you recall, it was right before the Christmas recess, the time was running out, and we were under deadlines on the floor. The decision was made at that time that it was impossible to address inequity at that point of proceedings on the bill, but a commitment was made by the chairman of the committee and others to have hearings and to examine the problem that was created, that we were treating two different kinds of vehicles that really had the same purposes differently.

Piggyback trailers now pay the full 12-percent Federal sales tax, even though they travel the same road mileage as the RoadRailer, and they are designed to serve the same purpose as the RoadRailer. Of course, the basic difference between the RoadRailer and the piggyback trailer is that the RoadRailer has a set of train wheels to travel on the rail, while the piggyback trailer is lifted onto a flat car to travel on the rail. But both types of trailers travel about the same land mileage, which usually averages less than 3,000 miles a year.

Of course, that was the idea, that if we were putting a tax on vehicles because they tore up the roads and they should pay a portion of the upkeep of the roads, that those that were designed and were not going to be on the roads very much should pay a lesser amount or should have an exemption. So the RoadRailer was exempt, but the piggyback, which has exactly the same function, and travels about the same mileage, was not exempted. And this creates a competitive imbalance in the industries. Those companies that happen to have opted for RoadRailers end up being much better off than those companies that opted for the piggyback approach, even though they are filling exactly the same function and are sometimes in a competitive situation with each other.

So I think we can solve this problem. Piggyback trailers cost more to build, weigh about 1,000 pounds more than an over-the-road trailer. They are built differently, they are constructed differently, they cannot really be used interchangeably. Therefore, I think it can be done without much of an enforcement problem.

So I hope that the committee will give this serious consideration. Several of our colleagues—Senators Wallop, Matsunaga, Mitchell, Symms, Baucus, Pryor—as well as myself, all members of the committee, have joined in cosponsoring this legislation.

Mr. Chairman, I would just insert the rest of my statement in the record and say that hopefully we will give very serious consideration to this piece of legislation. I am pleased that this very able panel of experts has appeared to discuss it this morning.

Senator PACKWOOD. David, thank you.

Why don't you go right ahead, Mr. Finn?

STATEMENT OF RICHARD FINN, PRESIDENT, TRANSAMERICA INTERWAY, INC., NEW YORK, N.Y.

Mr. FINN. Thank you very much, Mr. Chairman, Senator.

My name is Richard Finn. I am president and chief executive officer of Transamerica Interway. We are a major owner of containers, piggyback trailers, and very importantly, also, over-the-road trailers which we rent, and we are an ICC-regulated trucking company. So in the sense that there is any issue between us and truckers, we are on both sides of the fence.

I am pleased to speak in favor of S. 1231, which would exempt the piggyback trailers from the 12-percent excise tax.

Under last year's Surface Transportation Assistance Act, both the over-the-road trailers, which are major highway users, and the piggyback trailers, which travel much less on road and more on rail, pay the same 12 percent.

However, Piggyback trailers and of course the roadrailer, which Senator Boren has already mentioned, use the roads much less each year than the large long-haul over-the-road trailers. Our over-the-road trailers average about 50-60,000 a miles a year. Piggyback trailers, based on the samples that we did in 1978 and 1981 run below 3,000. So there is a tremendous difference in ratio of mileage over-the-road used.

The 12-percent excise tax, as I understand it, was aimed at getting heavy road users to pay for the highway maintenance that they cause. But piggyback trailers, as we have said, do not significantly damage the highway, simply because they do not go over the road that many miles. Therefore, we feel very strongly that an exemption for piggyback trailers makes sense.

As we have already noted, the principle of an exemption for low-mileage users of highways has already been recognized by the exemption for the roadrailer, which, as Senator Boren mentioned, is simply a modified piggyback trailer.

We think that the exemption should help to encourage the use of rail for long-haul freight, which we believe is a positive thing for the country, in the sense that it will offset the basic increased cost of bringing up the spec of a trailer to Piggyback use. You have to put on lift pads, you have to put on extra locking bars on the doors, and that costs an additional amount of money. Furthermore, of course, it increases the weight, if that is significant for you. And if you increase weight, obviously over the life of a trailer you will increase the fuel use that the trailer incurs.

We believe that the administration of an exemption would be simple. All of our trailers, for example, are certified by the AAR. They would have to meet that certification. And because they require those additional features initially to meet such certification, we doubt that many people would want to incur those additional features and the additional weight in order to circumvent the 12-percent tax.

As far as the cost of the exemption to the Treasury, which certainly is an important factor, we believe it would not be that significant. There are not that many piggyback trailers in the country—about 145,000. We think you might need to replace and increase the volume by about 12,000 trailers a year. So our estimate of the revenue loss is about $13 million per annum.

So basically we feel strongly that we should get an exemption for Piggyback. I was disappointed to hear that the Department of Transportation indicated that they were not in favor of this, because in their Federal Highway Cost Allocation Study in May of 1982 they said, "piggyback trailers: Consideration should be given to relieving truck trailers that are manufactured for use as piggyback trailers, trailers transported by rail for the line haul portion of the trip, of the new truck excise tax." That's what they said in May of 1982. They now apparently oppose it, and we will have to find out why.

Thank you.

Senator PACKWOOD. Thank you. Ms. Batts.

[Mr. Finn's prepared statement follows:]

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STATEMENT OF

RICHARD H. FINN

PRESIDENT AND CHIEF EXECUTIVE OFFICER

OF

TRANSAMERICA INTERWAY INC.

IN SUPPORT OF S. 1231

October 28, 1983

I am pleased to submit this Statement in support of S. 1231, a bill to amend the Internal Revenue Code of 1954 to exempt certain Piggyback trailers and semi-trailers from the Federal excise tax on motor vehicles.

TRANSAMERICA INTERWAY

Transamerica Interway is a subsidiary of Transamerica Corporation, a diversified public company. Headquartered in San Francisco, Transamerica employs approximately 26,000 employees throughout the United States working for a number of diverse subsidiaries including Transamerica Airlines, Transamerica Occidental Life, Transamerica Delaval and Budget Rent a Car.

Transamerica Interway operates through various subsidiaries including Transamerica Trailer Services, which leases over-the-road trailers; Transamerica ICS, which leases intermodal freight containers and chassis; Transamerica Transportation Services, our Piggyback trailer Lessor; and two subsidiaries engaged in freight transportation, including an over-the-road Interstate Commerce regulated trucking company. (Parenthetically, at this point I would observe that even though we own, operate and lease over-the-road trailers, we are only endorsing an exemption for Piggyback trailers.)

Transamerica Interway's subsidiary, Transamerica Transportation Services (TTS) owns, operates and leases a fleet of about 36,000 Piggyback trailers. As such, TTS is the largest owner of Piggyback trailers in the United States. Its principal lessees are United States railroads. TTS leases its Piggyback trailers both on a medium term and short term basis. The major thrust of TTS' leasing business is providing approximately 20,000 trailers on a pool basis, wherein the Piggyback trailers are interchanged from one user to another, as the freight moves from origination point to ultimate consignee. With the transfer of possession of one of our Piggyback trailers, all of the lease obligations simultaneously pass from one user to the other.

PIGGYBACK TRAILERS

Piggyback trailers are, as indicated above, operated primarily by the nation's railroads for the transportation of freight on rail flatcars for the long distance line haul and briefly on local streets and highways for pick-up and delivery. Piggyback trailers are visually similar in overall design to trailers which are primarily used over the road (OTR Trailers). However, Piggyback trailers are significantly modified and strengthened in order to withstand the rigors of their primary use, i.e. in trailer-on-rail-flatcar (TOFC) service. Attached as Exhibit I is a listing of components required by the Association of American Railroads (AAR Trailer Specification M-931) for Piggyback trailer certification together with the additional weight and cost of each component.

ROAD VS. RAIL USAGE OF PIGGYBACK TRAILERS

Piggyback trailers perform the vast majority of their transport function on railroad flatcars and not on the highways. Several studies conducted by TTS have established that Piggyback trailers travel insignificant amounts on the highways compared to OTR trailers. Indeed, OTR trailers travel on the road somewhere between 10 to 20 times the annual road mileage of Piggyback trailers.

In 1981 a survey by TTS concluded that a sampling of 62 Piggyback trailers equipped with hubodometers, traveled on average 2,432 miles on the road. A similar survey in 1978 produced an average of 1,406 miles. We would point out also that based on our experience, a large portion of the road mileage traveled by Piggyback trailers is on local streets and not major and interstate highways. The Department of Transportation on the other hand has calculated the average annual mileage for all heavy tractor trailer combinations over 75,000 lbs. GVW at 67,930 miles. Thus, we feel is it reasonable to conclude that Piggyback trailer's usage of interstate roads is insignificant compared to OTR trailers.

EXCISE TAX STATUS OF PIGGYBACK TRAILERS

At the time that the Department of Transportation was preparing its Final Report on the Federal Highway Cost Allocation Study, Transamerica Interway first raised the issue of the fairness of the application of the excise tax to Piggyback trailers. We submitted a detailed and exhaustive brief outlining the inequities in the application of the tax to Piggyback trailers. In its Final Report DOT said:

> "Consideration should be given to relieving truck trailers that are manufactured for use as piggyback trailers from the new truck excise tax."

We owners of Piggyback trailers must admit that we missed the boat when we did not get an exemption written into the Surface Transportation Assistance Act of 1982. We were alerted to action in early December of 1982 when we discovered that included in the House Bill was an excise tax exemption for the so-called RoadRailer. We were, however, too late, and the exemption for the RoadRailer passed with the 1982 Act. Meanwhile Piggyback trailers are taxed at a rate of 12% of the retail purchase price. It is important to our position to understand that the RoadRailer is nothing more than a

Piggyback trailer with a set of rail wheels. Visually they look very similar as can be seen by reference to the cover page of Exhibit II. The RoadRailer spends most of its time on the rails and as near as we can tell no more or less time than a Piggyback trailer on the roads.

We agree fully with the Congress that the RoadRailer is entitled to the excise tax exemption it now has. We only ask that Piggyback trailers have the same exemption for the exact same reasons that prompted Congress to give the RoadRailer its exemption in the 1982 Act.

S. 1231 WILL HELP TO PROMOTE THE USE OF TOFC

Transamerica Interway has prepared a booklet which we have attached to this Statement as Exhibit II. That booklet points up some of the desirable results that will be obtained from encouraging and promoting the use of the Piggyback mode of transport. In addition to the obvious one of taking heavy trailers off the roads, with the resulting benefits in cost savings to the nation's highways, Piggyback is safer to human life and is more fuel efficient.

COST TO THE TREASURY

We estimate that an exemption for Piggyback trailers would cost the treasury above $13 million per year for the six years that the excise tax on heavy vehicles is currently in effect for. Exhibit II details how we have arrived at that sum.

We would urge, however, that fairness both in relation to the RoadRailer exemption and fairness in relation to the underlying theory of the excise tax, dictates that Piggyback trailers have an exemption. We understand that the underlying rationale for the excise tax is to place an additional cost on heavy vehicles because of the damage they cause to the highways. For example, there is no excise tax on most automobiles because the theory says they do not do material damage to the roads. But Piggyback trailers are designed for and used primarily off the roads and on the rails, so that the logic dictates that they not be required to pay an excise tax since they also do not do material damage to the roads.

TAX AVOIDANCE

The possibility has been suggested that a Piggyback trailer exemption will be difficult to enforce because OTR trailer owners would get their trailers certified as Piggyback trailers. We believe that the economics of the situation dictate against that result. As our Exhibit I shows, the approximately $1,000 of additional cost and the added weight to the trailer of 1,138 pounds would make it highly unattractive both in initial cost and in ongoing operating costs for one to purchase Piggyback trailers for predominant use in over-the-road service.

EXHIBIT I

WEIGHT AND COST OF COMPONENTS REQUIRED ON AAR CERTIFIED PIGGYBACK TRAILERS AND NOT FOUND ON STANDARD OVER-THE-ROAD TRAILERS

COMPONENT	REMARKS	ADDED WEIGHT/TRAILER	ADDED COST/TRAILER
1. LIFT PADS	REQUIRED FOR BOTTOM RAIL PROTECTION WHEN LIFTING PIGGYBACK TRAILER ONTO FLATCAR.	350 lbs.	$300
2. STANCHION PLATE	REQUIRED TO PROTECT UNDERSIDE OF PIGGYBACK TRAILER WHEN POSITIONING IT ON FLATCAR.	70 lbs.	$ 48
3. EXTRA DOOR HARDWARE	4 HEAVY DUTY LOCKING BARS ON PIGGYBACK TRAILER DOOR VS. 2 LIGHT DUTY LOCKING BARS ON OTR TRAILER DOOR.	106 lbs.	$146
4. EXTRA DOOR THICKNESS	1 1/4" THICK PLYMETAL DOOR WITH 10 HEAVY DUTY HINGES ON PIGGYBACK TRAILER VS. 3/4" THICK DOOR WITH 6 HINGES ON OTR TRAILER.	165 lbs.	$238
5. FRONT CONSTRUCTION	HEAVY DUTY FRAME CONSTRUCTION WITH 3/4" THICK PLYWOOD LINER ON PIGGYBACK TRAILER VS. LIGHT DUTY FRAME CONSTRUCTION AND 1/4" THICK PLYWOOD LINER ON OTR TRAILER. ALSO, FITTINGS ON PIGGYBACK TRAILER MUST BE RECESSED AND A MANIFEST BOX MUST BE INSTALLED.	138 lbs.	$121
6. SIDE POSTS	HEAVY DUTY SIDE POSTS ON PIGGYBACK TRAILER.	144 lbs.	$ 50
7. LANDING GEAR	HEAVY DUTY SUPPORT MEMBERS ON PIGGYBACK TRAILER.	30 lbs.	$ 24
8. KING PIN ASSEMBLY	HEAVIER PICK-UP PLATE KING PIN AND SUPPORT MEMBERS ON PIGGYBACK TRAILER.	60 lbs.	$ 30
9. SUSPENSION	4 PIN SLIDE ASSEMBLY ON PIGGYBACK TRAILER VS. 2 PIN ASSEMBLY ON OTR TRAILER.	75 lbs.	$ 20
TOTAL		1138 lbs.	$977

Transamerica Interway

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Dennis J. Kenny
Vice President-General Counsel

October 28, 1983

Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. DeArment:

We at Transamerica Interway want to thank you for the opportunity for our President and Chief Executive Officer, Richard H. Finn, to testify today in favor of S. 1231, introduced by Senator Boren and which would exempt certain piggyback trailers from the Federal Excise Tax.

We have been authorized by each of the firms and corporations listed on the attachment hereto to advise you and the Committee that they endorse our testimony and position in favor of S. 1231.

Very truly yours,

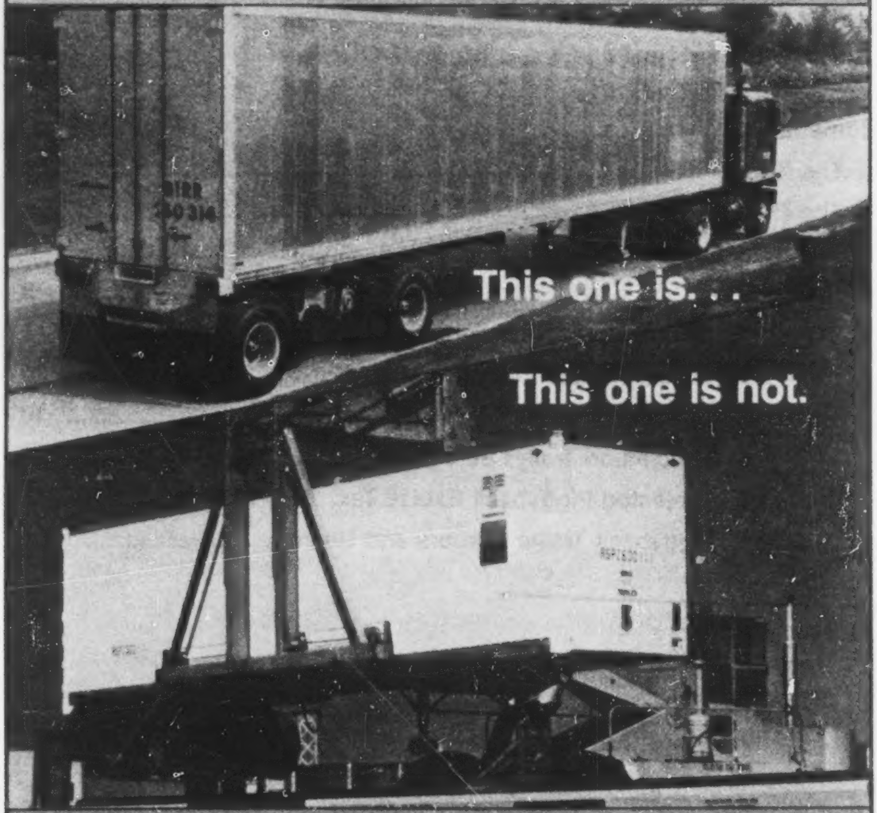
DJK/ecc
Attachment

Transamerica Interway

EXHIBIT II

THE SURFACE TRANSPORTATION ASSISTANCE ACT OF 1982

Should only one of these be exempt from the Federal Excise Tax?



This one is. . .

This one is not.

These are the facts. . . .

April 1983

Transamerica
Interway

Transamerica Interway Inc.*
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PIGGYBACK TRAILERS

The Case for Exemption from the Federal Excise Tax

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*Transamerica Interway: See Appendix A

1. The Problem

- Under the Surface Transportation Assistance Act of 1982, over-the-road (OTR) trailers, which travel on the highways an average well over 60,000 miles a year, pay the full 12% Federal Excise Tax.
- Piggyback trailers, which in contrast use the highways an average of well under 3,000 miles per year, also pay the full 12% Federal Excise Tax.
- RoadRailer trailers, however, which travel the same low mileage on the highways as Piggybacks, are exempted from the 12% Federal Excise Tax by the Surface Transportation Assistance Act of 1982.

Like RoadRailers, Piggybacks are significantly different from over-the-road trailers. While similar in overall design to an OTR trailer, Piggybacks are modified and strengthened for trailer-on-rail-flatcar (TOFC) service. They are operated primarily by the nation's railroads for the intermodal transportation of freight, traveling on railroad flatcars for the long distance line-haul and by highway for local pick-up and delivery. Piggyback trailers are also used by water carriers for transport aboard roll-on/roll-off vessels. Piggyback trailers consequently perform the vast majority of their function off the highways.

The purpose of the Federal Excise Tax is to generate funds to expand and maintain the Nation's highway system. The imposition, therefore, of the tax equally to OTR and Piggyback trailers is clearly inequitable. Furthermore, it is not consistent with the intent of Congress in creating the Highway Trust Fund, that the tax burden necessary to maintain and develop the highways be equitably distributed among the highway users in accordance with their use.*

The fact that Piggyback trailers must pay the full Excise Tax flies in the face of a statement made by the Department of Transportation in May of 1982 in its Final Report on the Federal Highway Cost Allocation Study. DOT said:

> Consideration should be given to relieving truck trailers that are manufactured for use as piggyback trailers from the new truck excise tax. [I-14.]

In the closing hours of the 97th Congress, during exhaustive debate of the Surface Transportation Assistance Act of 1982, Piggyback trailers were included in the Federal Excise Tax. RoadRailers were exempted!

In a colloquy on the Floor of the U.S. Senate during this debate, Senator David Boren (D-OK) said:

> . . . Mr. Chairman . . . Could I ask . . . if the committee would look at the entire area to assure the equal treatment of various types of piggyback vehicles in the next session through hearings with a view toward possible corrective legislation?

Finance Committee Chairman Robert Dole (R-KS) replied:

> I can assure the Senator that the committee will have an opportunity to consider this issue

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* See Senate Report No. 2054, 84th Cong., 2nd Sess. (1956); See generally Congressional Budget Office, *Highway Assistance Programs: A Historical Perspective* (Feb 1978).

next year. [Congressional Record Dec. 20, 1982 S 15733.]

Senator Boren has agreed during the 98th Congress to introduce legislation to exempt Piggyback trailers from the Federal Excise Tax.

2. The Facts

● Road Mileage Contrasted

☐ OTR Trailers
The Department of Transportation has calculated the average annual highway mileage for all heavy tractor trailers at 67,930 miles.*

☐ Piggyback Trailers
Transamerica Interway has calculated the average annual highway mileage for Piggyback trailers to be 2,432 miles.**

☐ RoadRailer
RoadRailer is nothing more than a modified Piggyback trailer, the major difference being a set of rail wheels in addition to road wheels. The RoadRailer, like the Piggyback, does very few miles over the highways. Transamerica Interway estimates the RoadRailer's over-the-road mileage to be the same as a Piggyback trailer.

● Cost Saving to the Nation's Highways
Each OTR trailer diverted to the rails would result in a reduction to the nation of a minimum of $3,200 per year in road maintenance and repair.***

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* See Appendix B.

** See Appendix C.

*** Annual cost responsibility of a heavy truck-trailer combination (over 75,000 lbs.) Final Report on the Federal Highway cost Allocation Study, Table VI-II (page VI-34).

- Piggyback Safety****

Each OTR trailer diverted to the rails would contribute substantially to the safety of human life.

In 1980, the incidence of fatalities involving heavy trucks was 607 times greater than that for railroads per ton mile.

In 1981 the heavy truck fatality incidence increased to 1,392 times that for railroads per ton mile.

The following table shows the fatality relationship between rail and heavy truck on an intercity ton mile basis.

FATALITIES PER HUNDRED MILLION INTERCITY TON MILES

Mode	Year	Ton Miles (Hundred Million)	Total Fatalities	Fatalities (Per Hundred Million Ton Miles)
Rail	1980	918.62	29	.03
Heavy trucks	1980	242.20	4,642	19.17
Rail	1981	911.71	13	.01
Heavy trucks	1981	240.70	4,756	19.71

Sources: Association of American Railroads
American Trucking Association

- Piggyback Fuel Economy

Piggyback is substantially more fuel efficient than truck.

In a 1980 paper presented to the Transportation Research Board entitled "The Energy Crisis and Intermodal Competition" it was determined that long-haul trailer on flat car service when

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**** See also Appendix D.

compared to truck had a relative energy efficiency advantage of 2.3 to 1.

"Energy Use in Freight Transportation" a report prepared by the Congressional Budget Office, found that on the basis of actual energy used to move freight, rails prove to be three times as efficient as trucks.

- Projected Piggyback Excise Tax, 1983-1988
Transamerica Interway estimates that over the next six years approximately 62,000 Piggyback trailers will be acquired in the United States at a cost of approximately $650 million. At a 12% excise tax rate, the cost of exempting Piggyback trailers from the excise tax would be approximately $78 million or $13 million per year.*

3. The Solution

As of November 1982, approximately 154,000 Piggyback trailers were officially listed with the vast majority being owned by railroads and leasing companies.**

To exempt Piggyback trailers from the excise tax would cost the Treasury about $13 million a year on average over the next six years. However, we urge that the proper perspective for a Piggyback trailer exemption is one of fairness in relation to the RoadRailer and more importantly to recognize the dollar savings to the nation ($3,200 per year per diverted vehicle) that would result in highway maintenance and repair costs.

The exemption of Piggyback trailers from the excise tax would not require any administrative or

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*See Appendix E

** See Appendix F

enforcement burden. Piggyback trailers are distinguishable from ordinary over-the-road trailers, and they incur a cost and weight penalty that would preclude OTR operators from purchasing Piggyback trailers simply to avoid payment of the excise tax. Congress has already recognized the distinction between certain classes of vehicles in the application of the excise tax, and has exempted other vehicles which make minimal use of the highway, e.g., mining, construction and farm vehicles and RoadRailers.

It is clear that there is no material difference between a RoadRailer and a Piggyback trailer either in their intermodal operation or in the benefits they derive to the U.S. highway system. Indeed, if anything, Piggyback trailers when on the highways may do less road damage than the RoadRailer because of the added weight of rail wheels on the RoadRailer.

Piggyback trailers are clearly in the national interest. They help to lessen traffic congestion, are safer than OTR trailers to human life and property, are fuel efficient, cause less pollution and save highways. Not only should Piggyback trailers be exempt from the Federal Excise Tax, but Congress should undertake by legislative inducement to get trailers off the roads and onto the rails. Removal of the excise tax is one way to do that. This is consistent with the Congressional policy of promoting intermodal domestic forms of transport.*

We agree, the RoadRailer should have an exemption from the excise tax. BUT FOR THE VERY SAME REASONS SO SHOULD PIGGYBACK

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* Motor Carrier Act of 1980, Pub. L. No. 96-296, Para. 4

TRAILERS. Therefore, Transamerica Interway advocates legislation to exempt Piggyback trailers from the Federal Excise Tax imposed by the Surface Transportation Assistance Act of 1982.

Appendix A Transamerica Interway

Transamerica Interway is a subsidiary of Transamerica Corporation, a diversified public company. Headquartered in San Francisco, Transamerica employs approximately 26,000 employees throughout the United States. Besides Transamerica Interway, these subsidiaries include Transamerica Airlines, Transamerica Occidental Life, Transamerica Delaval and Budget Rent a Car.

Transamerica Interway's subsidiary, Transamerica Transportation Services (TTS) owns, operates and leases a fleet of about 36,000 piggyback trailers. As such, TTS is the largest owner of piggyback trailers in the United States.

Transamerica Interway is also engaged through another subsidiary, Transamerica Distribution Services, in the business of transporting temperature-controlled commodities—primarily fresh produce—in refrigerated piggyback trailers (reefers) in transcontinental intermodal service. This subsidiary operates 500 refrigerated trailers whose long hauls (as opposed to the short-haul collection and distribution) are exclusively undertaken by rail.

Transamerica Interway is also engaged in the repair and maintenance of its own and others' piggyback equipment in the U.S. through Transamerica Intermodal Maintenance Services, which operates 11 repair shops and more than 200 mobile service units.

A total of 634 employees of Transamerica Interway and its subsidiaries are involved in piggyback trailer activities. These employees are located in the major railroad transportation hubs of the New York Area, Atlanta, Chicago, Miami, Philadelphia and the San Francisco Area.

These employees owe their jobs to the fact, as reported by Modern Railroads, that "Leasing companies have met railroad needs for trailers in good times and bad."

In the Greater New York Area, where Transamerica Interway has had its corporate headquarters since 1963, approximately 150 employees are engaged in serving the piggyback trailer industry.

In the Chicago Area, the nation's biggest railroad hub, a total of 273 people are employed in two localities.

In Miami, Florida, the hub for roll-on/roll-off steamship interchanges of piggyback trailers with the railroads—and a key area for trade with the Caribbean and South America—105 people are employed, the majority in maintenance and repair work.

On the West Coast in Oakland and Los Angeles, a total of 48 people are in the Company's employ serving piggyback trailers.

In Atlanta, 58 people are employed in piggyback operations.

Appendix B

Over-the-Road Trailer Highway Mileage

The Department of Transportation has calculated that the average annual mileage for all heavy tractor-trailer combinations over 75,000 lbs. GVW at 67,930 miles.*

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* Source: "Final Report on the Federal Highway Cost Allocation Study"—U.S. Department of Transportation. (Calculation based on tables IV-12 and IV-15—year 1977. Original base data "1977 Truck Inventory and Use Survey"—Bureau of the Census.)

Appendix C

Piggyback Trailer Highway Mileage

In order to obtain an indication of the average annual mileage travelled by Transamerica Transportation Services' piggyback trailers on public highways, TTS personnel in April 1981 located all TTS trailers on which hubodometers had been installed at the time of purchase. Sixty-two such trailers were located nationwide. The identification numbers and hubodometer readings from these trailers were recorded.

From purchase records the number of months which had elapsed since the acquisition of each trailer was computed.

An average monthly mileage was obtained by dividing the hubodometer reading for each trailer by that trailer's months in service. This figure was then multiplied by 12 to get an average yearly mileage for each trailer. Based on the foregoing facts and calculations it was found that the average yearly miles for each trailer was 2,432 miles.

In addition, during a three-month period in 1978 TTS extracted a sample of 493 piggyback trailer hubodometer readings from tire repair worksheets. The data from these worksheets showed an average annual mileage of 1,406 miles per trailer.

Average Annual Mileage of Transamerica Piggyback Trailers

Trailer identification number	Date purchased Mo.-Yr.	Months in service	Hubodometer reading	Average monthly mileage divided by months in service	Average annual mileage (monthly mileage times twelve)
304146	10-72	103	13119	186	2232
303238	7-70	130	10603	82	984
298837	6-73	95	13013	137	1644
299297	8-72	105	30547	291	3492
204464	10-68	151	30077	199	2388
285299	7-70	130	39511	304	3648
200050	8-69	141	54595	387	4644
284614	3-74	86	19511	227	2724
205740	1-70	136	13719	101	1212
306035	11071	114	13381	117	1404
703650	5-69	144	32819	228	3736
701499	3-68	158	27674	175	2100
205543	9-67	164	23227	142	1704
700129	5-67	168	23212	138	1656
701484	3-68	158	25886	164	1968
284035	7-70	130	91447	703	8436
286700	9-74	80	20109	251	3012
281719	11-73	90	15636	174	2088
791382	7-70	130	28081	216	2592
282922	7-70	130	100648	774	9288
284641	3-74	86	19450	226	2712
286680	7-76	58	11488	198	2376
284119	10-68	127	73828	581	6972
202268	10-68	151	30147	200	2400
303976	12-71	113	12939	115	1380
302312	6-70	131	8994	69	828
303309	1-74	88	6116	70	840
304590	12-70	125	22870	183	2196
791301	8-70	129	22942	178	2136
705358	5-67	168	32651	194	2328
207686	11-68	150	18011	1200	1440
284075	10-75	67	19690	294	3528
706157	1-69	148	22441	152	1824
281753	4-74	85	10609	125	2280
293761	10-70	127	22942	181	2172
202192	4-67	169	30129	178	2136
284576	6-74	83	67629	815	9780
282920	6-74	83	16710	201	2412

**Transamerica
Interway**

Average Annual Mileage of Transamerica Piggyback Trailers

Trailer identification number	Date purchased Mo.-Yr.	Months in service	Hubodometer reading	Average monthly mileage divided by months in service	Average annual mileage (monthly mileage times twelve)
20342	9-68	152	22816	150	1800
284622	6-74	83	18027	217	2604
202634	6-69	143	20426	143	1716
202613	6-69	143	15508	108	1296
701380	3-68	158	23687	150	1800
204050	4-66	181	10029	55	660
202647	11-69	138	14969	108	1296
284656	3-74	86	17189	200	2400
205749	12-69	137	10725	78	936
207690	5-68	156	15207	97	1164
208216	11-69	138	15681	114	1368
201974	9-69	140	16637	119	1428
281640	1-73	100	17872	179	2148
208218	11-69	138	17154	124	1488
202966	10-69	139	14453	104	1248
207661	11-68	150	16549	110	1320
305081	10-65	187	14121	76	912
207682	11-68	150	3264	22	264
791313	1-70	136	7990	59	708
289464	12-68	149	18059	122	1464
					2432*

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*Average mileage per trailer

Appendix D

IN THE NATION

Welcome, Killer Trucks

By Tom Wicker

"Just in time for Christmas, the lame-duck session of the 97th Congress handed a lavish gift to the truck and highway lobbies — killer trucks four times more lethal to human life than a passenger automobile and exponentially more destructive of the roads than any other vehicle.

Laws banning 65-foot tandem trailers — two trailers hitched together — from the highways of 14 states were effectively overridden, beginning April 1, 1983. After that, states that continue to ban these behemoths (which with a cab to haul them can be 75 to 80 feet long) could lose Federal highway aid; none will likely risk it.

The same legislation will permit such trucks to be widened from 96 to 102 inches, and to be heavier by 6,720 pounds, up to a total of 80,000 pounds (the weight of machine and cargo combined).

Nine months after the law takes effect, moreover, these killer trucks are also to be allowed on city streets that serve as access lanes to the interstate highways or to truck terminals, major pickup points and fuel depots.

For New York City, which has no bypass or circumferential highways, the state Department of Transportation says the practical effect will be to open *all city streets* to this destructive new traffic. The legislation — part of the law increasing the Federal gasoline tax — overrides a city ordinance restricting trucks to less than 55 feet in length, 96 inches in width and a maximum weight of 73,280 pounds.

Battered and jolted New Yorkers do not need to be told what new depredations the killer trucks will wreak on the pot-holed streets that already advertise the city's fiscal crisis. But even New Yorkers, weaned as they are on bad news, may not be aware that every *year one of three* tandem-trailer trucks has an accident, compared to one of only 12 highway vehicles overall.

And if one of these frequent killer-truck accidents happens to involve a passenger car, the Center for Auto Safety reports, the occupant of the car is 29 times more likely to die than the occupant of the truck.

In 1981, according to the Fatal Accident Reporting System of the Federal Department of Transportation, there were 2.86 fatalities per 100 million vehicle miles traveled in passenger cars, 5.6 fatalities for the same traffic in single trucks and *12.2 fatalities per 100 million tandem-truck miles.*

Those figures probably will get worse under the new weight allowance, because Congress made no requirement for improved braking systems (as it did when it last increased allowable truck weights). The 80,000-pounders can go right on using brakes designed for lighter trucks.

But these are killer trucks for highways as well as people. The interstate system, in fact, was constructed for maximum weights of 60,000 pounds, against the 80,000 pounds now to be allowed. Federal highway officials estimate that the destructive impact of a single 80,000-pound truck is as great as that of 9,600 passenger cars moving over the same stretch of road.

Put another way, an 80,000-pound, five-axle truck weighs only as much as about 20 cars. But a study by the American Association of State Highway and Transportation Officials shows that pavement damage increases exponentially (to the fourth power) with increases in axle weight. So the weight increase just allowed by the lame-ducks will result in a *highway damage increase* of about 15 percent.

Thus, legislation aimed at repairing the highways includes provisions guaranteed to damage them as fast as they're rebuilt; some experts think the increased damage will more than offset the increased tax revenues. And don't kid yourself that the trucking companies will be paying their fair share of the costs.

A D.O.T. cost allocation study, based on 1977, showed that auto drivers were paying 110 percent of the maintenance costs of highway damage for which they were responsible; trucks were paying only 79 percent of repair costs for the damage they caused; and trucks weighing over 75,000 pounds were paying *only 45 percent* of their true share. Georgia and Florida studies confirmed the Federal figures.

The lame-duck bill won't come close to removing this inequity, which results from the greater damage done by larger vehicles. The D.O.T. legislation originally boosted the average annual fees and taxes on commercial trucks from about $250 to about $2,700; the House cut that to $2,200, the Senate to $1,600 and the conference committee added a provision that overall fees could average no more than $1,900 by 1988.

Truckers will be paying the new gas tax too; but they're still getting off lightly. In fact, they may never pay the higher fees, because the lame-ducks thoughtfully decided not to put them into effect until July 1, 1984.

That gives truck lobbyists a year and a half to get the new fees repealed or modified. After the gift they just extracted from Congress, for which the rest of us will pay in lives, money and discomfort, don't bet they can't do it.

Reprinted from the NEW YORK TIMES, January 16, 1983

IN THE NATION

Killer Trucks, Indeed

By Tom Wicker

The American Trucking Associations has responded with outrage and specious "facts" to the assertion in this space on Jan. 16 that Congress had unleashed "killer trucks four times more lethal to human life than a passenger automobile and exponentially more destructive of the roads than any other vehicle."

This charge is so well-substantiated that I welcome the opportunity to repeat it, and to point out the self-serving nature of the truckers' response (a letter to the editor of The New York Times, published Feb. 1, from the associations' president, Bennett C. Whitlock Jr.).

The truck lobby pushed legislation through the lame-duck session of Congress effectively overriding the laws of 14 states prohibiting 65-foot tandem-trailer trucks on their highways. States that continue to ban such monsters after April 1 could lose Federal highway aid. Other new legislation permits such trucks to be widened from 96 to 102 inches, and to be heavier by 6,720 pounds, up to a total of 80,000 pounds (cargo and rig combined).

Mr. Whitlock disputed my statement that the Interstate Highway System "was constructed for maximum weights of 60,000 pounds," citing as his only evidence that it was "a defense highway system" supposed to carry "the heaviest of military vehicles."

But I didn't make that point strongly or clearly enough. Interstate highways were so designed that an average maximum of 60,000 pounds would be about ideal. On some sectors the maximum design load is less; on many others 73,000 pounds would be permissible. Nowhere should the average be as high as 80,000 pounds, most engineers believe.

But engineers also say the best measure of highway design is in the number of anticipated axle loads over the life of the pavement. And the Federal Department of Transportation's 1981 report, "The Status of the Nation's Highways," pointed out that the interstate system's designers had underestimated its future use, "particularly the growth of the long-distance trucking industry. This intensity of use has caused the usable design life to be reached sooner than anticipated in many segments."

Department engineers estimate, moreover, that if every 60,000-pound truck became an 80,000-pounder, pavement damage would triple; and that if axle loads increased from 18,000 to 20,000 pounds (which is about what's happening), the result would be a 25 to 40 percent loss of pavement life.

Mr. Whitlock further claimed, with no more evidence, that a report of the American Association of State Highway and Transportation Officials, citing excessive highway damage by heavy trucks, had been "discredited." On the contrary, that study is "used absolutely everywhere," says Roger Mingo, chief engineer for D.O.T.'s Cost Allocation Study.

The D.O.T.'s own study, published in May 1982, asserts that the heaviest trucks do "at least 87 times as much damage to the pavement as the heaviest auto." The findings of both documents are confirmed by numerous state studies as easily available to Mr. Whitlock as to me.

I claimed a fatality rate of 12.2 per 100 million miles for tandem-trailers (the rate is only 2.98 per 100 million miles of passenger vehicle traffic) and attributed the information to the D.O.T.'s Fatal Accident Reporting System. But that system, Mr. Whitlock triumphantly claims, "does not even develop fatality rates."

No, it only reports fatalities. But the Federal Highway Administration compiles mileage figures for various vehicles; so if you have no vested interest like Mr. Whitlock's, you can combine the two and use simple arithmetic to work out fatality rates.

Mr. Whitlock is proud that only 177 highway deaths of a total of 49,392 occurred in accidents involving tandems in 1981. The figure is meaningless; fewer than one in a thousand of the 139 million registered vehicles on the highways are tandems. They can never cause a high percentage of all traffic deaths. And he did not even try to refute the fact that in a tandem accident involving a passenger car, an occupant of the car is 29 times likelier to die than the truck driver.

Thirty-six states already accept tandem-trailers and only three states have gross-weight maximums of less than 80,000 pounds, Mr. Whitlock writes. That does not change the fact that 14 states' laws are being overridden; and it omits mention of New York, Boston and other cities being forced by the new legislation to open their battered streets to these destructive killer trucks.

Mr. Whitlock was shrewd enough not even to debate another point I raised — that despite higher taxes to be levied after July 1, 1984, heavy trucks still will pay nowhere near the cost of the highway damage they do. At the moment, the D.O.T. estimates that trucks weighing over 75,000 pounds pay only 45 percent of their true share of maintenance costs.

(My assistant, Michael Specter, deserves credit for research on both my articles about killer trucks.)

Reprinted from the NEW YORK TIMES, February 4, 1983

Appendix E

Projected Piggyback Excise Tax, 1983-1988

Transamerica Interway estimates that over the next six years a total of approximately 62,000 piggyback trailers will be acquired in the United States at a cost of approximately $650 million (in constant, 1983 dollars). At a 12% excise tax rate, the loss in revenues to the Treasury of exempting piggyback trailers from excise tax will therefore be approximately $78 million or $13 million per year.

This figure is derived in the calculation below and in the Exhibits which follow:

Estimated industry piggyback fleet, August 1982	166,946[1]
Estimated utilization, in 1982	75%[2]
Normal utilization	85%[3]
Required fleet as of August 1982 ($^{75\%}/_{85\%}$)	147,305
Projected annual growth rate of piggyback freight	3.9%[4]
Required fleet as of August 1988	185,315
Required additions (185,315-166,946)	18,369
Projected annual replacement rate	5.8%[5]
Projected replacement units	58,098
Total additions plus replacements, at current average capacity of 2,799 cu. ft. per trailer[6]	76,467
Total additions plus replacements, at projected average capacity of 3,444 cu. ft. per trailer[6]	62,168
Average price (in 1983 dollars)	$10,500[7]
Total cost of new trailers, 1983-1988	$653 million
Excise tax rate	12%
Total excise tax 1983-1988	$78 million
Average annual excise tax 1983-1988 (in 1983 dollars)	$13 million

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[1] See Exhibit 1

[2] See Exhibit 2

[3] See Exhibit 3

[4] The historical growth in piggyback loadings 1971 to 1982 was 3.3% per year (see Exhibit 4), plus the historical growth in average trailer capacity 1971 to 1983 was approximately 0.6% per year (see Exhibit 6). Total growth rate of piggyback freight was approximately 3.9% per year. We anticipate this fairly constant trend to continue over the next six years.

[5] See exhibit 5

[6] See Exhibit 6

[7] Typical price of van trailer without tires and net of excise tax.

Exhibit 1

Estimated Industry Piggyback Fleet

Transamerica Transportation Services (TTS) piggyback fleet as of August 1982, per the Official Intermodal Equipment Register (OIER)	32,284[1]
TTS' actual fleet as of August 1982	36,017[2]
Correction factor	11.6%
Total industry piggyback fleet as of August 1982, per the OIER	149,593[3]
Corrected industry piggyback fleet as of August 1982, (11.6% correction factor)	166,946

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[1] TTS' number includes trailers on long term lease to railroads and bearing railroad markings

[2] Total figure includes units out of service, pending sale or disposal, etc.

[3] Corrected for an error of 6,500 in the Register which double counted Availco units.

Exhibit 2

Industry Piggyback Fleet Utilization, May 1982

Company Name	Total Trailers	Idle Trailers	Percent Utilization
Railroad Companies[2]			
Atchison, Topeka & Santa Fe	9223	1050	88.6
Burlington Northern	5084	1700	66.6
Chicago & North Western	1575	414	73.7
Chicago, Milw., St. Paul & Pacific	2251	755	66.5
Consolidated Rail Corporation	9128	3357	63.2
Denver & Rio Grande Western	194	32	83.5
Grand Trunk Western	1570	361	77.0
Illinois Central Gulf	1766	520	76.2
Family Lines	10408	300	97.1
Missouri-Kansas-Texas	242	76	68.6
Missouri Pacific	3772	600	84.1
Norfolk & Western	2854	914	68.0
St. Louis Southwestern	494	325	34.2
Soo Line	190	30	84.2

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[1] Based on the Official Intermodal Equipment Register, May 1982

[2] Idle Rail Trailer Survey by TTS Marketing Department, May 21, 1982 (includes rail and hybrid marks)

Industry Piggyback Fleet Utilization, May 1982 Continued

Company Name	Total Trailers	Idle Trailers	Percent Utilization
Southern Pacific	4005	867	78.4
Southern Railway	10570	1751	83.4
Union Pacific	1476	110	92.6
Western Pacific	896	167	81.4
Sub-total	65698	13329	79.7
Other Railroads (Excl. Vermont)	21238	4311	79.7[3]
	86936	17640	79.7
Leasing Companies[4]			
TTS/Rail	16376[6]	5857[6]	64.2
Xtra	15500[7]	6117[5]	60.5
Availco	8300	2406[5]	71.0
Vermont	2986	518[5]	82.7
Sub-total	43162	14898	65.5
Railroad + Leasing Company Sub-total	130098	32538	75.0
Water Carriers	10271		
Other Companies (Reefer Operations)	2685		
Total Piggyback Fleet	143054		

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[3] Assumed same level of utilization as the reporting railroads

[4] Pool (per diem) trailers only (excludes long term lease trailers

[5] Based on TTS/Rail Competitor Idle Van Report, April 1982

[6] TTS Fleet Utilization Report (excludes non-revenues)

[7] Xtra Annual Report

Transamerica
Interway

Exhibit 3

TTS/Rail
Average Overall Fleet Utilization
1971-1982

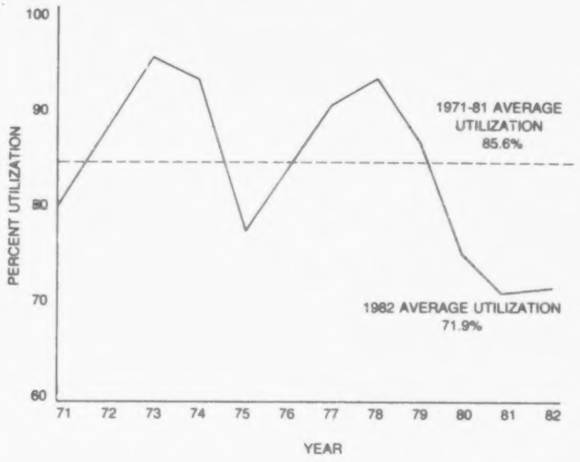
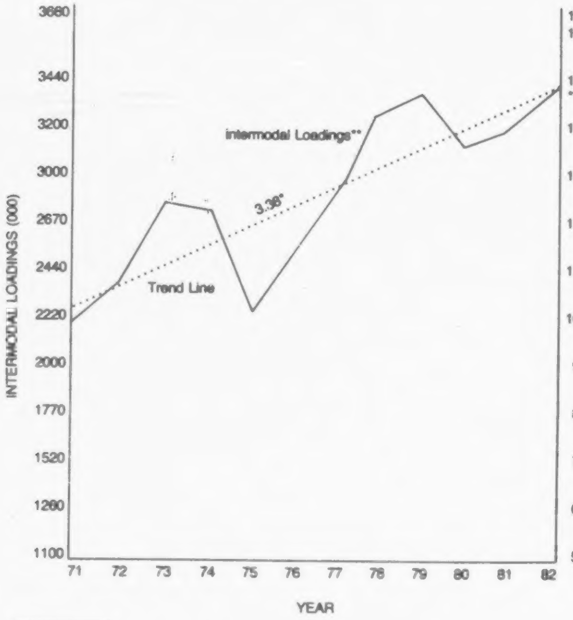


Exhibit 4

Intermodal Loadings Growth



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* Compound Annual Growth Rate

**Intermodal Loadings includes piggyback trailers and containers (approx. 25%)

Exhibit 5

Piggyback Fleet Growth And Replacements 1977-1982

Realco/TTS Piggyback Fleet at November 1977	30,023
Realco/TTS Piggyback Fleet at August 1982	36,017
1977-1982 Increase	5,994
1978-1982 Procurement	14,247
Replacements (14,247-5,994)	8,253
Replacements (%)	27.5

The average replacement rate for Realco/TTS during the 4¾ year period was therefore 5.8% per year. We believe our maintenance and replacement policies to be similar to those of the majority of the industry.

Exhibit 6

Capacity Adjustment For Larger Trailers

Estimated piggyback fleet composition at January 1971:

	Length		**Width**		**Height**	**Capacity (Cubic Feet)**
33%	40′	×	96″	×	12′6″	2470
33%	40′	×	96″	×	13′0″	2624
33%	40′	×	96″	×	13′6″	2779
	Average					2624

Current estimated piggyback fleet composition at January 1983:

	Length		**Width**		**Height**	**Capacity (Cubic Feet)**
10%	40′	×	96″	×	13′0″	2624
80%	40′	×	96″	×	13′6″	2779
10%	45′	×	96″	×	13′6″	3131
	Average					2799

Increase in average capacity of fleet from 1972 to 1983 = 7%
= 0.6% per year

Projected mix of new piggyback trailers acquired 1983-1988:

	Length		**Width**		**Height**	
50%	45′	×	102″	×	13′6″	3331
50%	48′	×	102″	×	13′6″	3556
	Average					3444

Increase in capacity of new trailers vs. current fleet mix = 23%

Appendix F Piggyback Trailer Owners And Users(1)

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Railroads(2)				
The Ahnapee and Western Railway Co.	500	2155 Hutson Road, P.O. Box 3603 Green Bay, WI 54303 (414) 497-5115		
American Rail Heritage, Ltd.	298	514 N. Market St. Marion, IL 62959		
The Atchison, Topeka and Santa Fe Railway Co.	9,283	80 East Jackson Blvd. Chicago, IL 60604 (312) 427-4900	34,735	IL, IN, IA, MO, KS, NE, OK, LA, CO, NM, AZ, CA, TX
The Baltimore and Ohio Railroad Company	3,840	The Terminal Tower, P.O. Box 6419 Cleveland, OH 44101 (216) 623-2200	15,417	NY, DE, PA, MD, DC, VA, WV, OH, IN, IL, KY, MO
Bangor and Aroostook Railroad Company	27	Northern Maine Junction Park RR2 Bangor, ME 04401 (207) 848-5711	681(3)	ME
Boston and Maine Corporation	564	Iron Horse Park N. Billerica, MA 01862 (617) 663-9300	3,146	MA, NH, ME, VT, NY
Brillion & Forest Junction Railway Co.	199	P.O. Box 10 Brillion, WI 54110 (414) 989-1916		
Burlington Northern Railroad Company	3,816	BN Building, 176 E. Fifth St. St. Paul, MN 55101 (612) 298-2121	55,347	AL, AR, CA, CO, FL, ID, IL, IA, KS, KY, MN, MS, MO, MT, NE, ND, OK, OR, SD, TN, TX, WA, WI, WY
The Chesapeake and Ohio Railway Co.	68	The Terminal Tower, P.O. Box 6419 Cleveland, OH 44101 (216) 623-2200	19,270	DC, VA, WV, KY, OH, IN, IL, MI, NY, NC
Chicago and North Western Transp. Co.	1,719	One North Western Center Chicago, IL 60606 (312) 559-7000	14,345	IL, WI, IA, MN, MI, ND, SD, WY, NE, MO, KS
Chicago, Milwaukee, St. Paul & Pacific Railroad Co.	2,110	Union Station, 516 W. Jackson Blvd. Chicago, IL 60606 (312) 648-3000	7,489	IL, IN, IA, MO, MI, MN, WI

Transamerica Interway

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Clarendon & Pittsford Railroad Co.	72	267 Battery Street Burlington, VT 05401 (802) 658-2550		
Columbus and Greenville Railway Co.	1,000	201 19th Street North, P.O. Box 6000 Columbus, MS 19701 (601) 328-6331		
Consolidated Rail Corporation	6,630	Transportation Center, 6 Penn Center Plaza Phila., PA 19104 (215) 977-4000	60,000	CT, DE, IN, IL, KY, MD, MA, MI, MO, NJ, NY, OH, PA, VA, DC, WV
The Denver and Rio Grande Western Railroad Co.	112	P.O. Box 5482 Denver, CO 80217 (303) 629-5533	3,652	CO, UT
Detroit Toledo and Ironton Railroad Co.	100	See Grand Trunk Western		OH, MI
East St. Louis Junction Railroad Co.	200	National Stock Yards, IL 62071	4	MO
Florida East Coast Railway Company	204	1 Malaga Street St. Augustine, FL 32084 (904) 829-3421	1,551	FL
Grafton and Upton Railroad Co.	563	P.O. Box 102 Shrewsbury, MA 01545		
Grand Trunk Western Railroad Co.	500	131 W. Lafayette Blvd. Detroit, MI 48226 (313) 962-2260	4,200	MI, IN, IL, OH
Hartford and Slocomb Railroad Co.	258	P.O. Box 2243 Dothan, AL 36301		
Hillsdale County Railway Company Inc.	200	50 Monroe Street Hillsdale, MI 49242 (517) 439-1434		
Illinois Central Gulf Railroad Company	1,738	233 N. Michigan Avenue Chicago, IL 60601 (312) 565-1600	16,000	IL, IN, IA, MN, SD, NE, KY, TN, MS, LA, AL, MO
Kankakee, Beaverville and Southern Railroad	3,300	P.O. Box 136 Beaverville, IL 60912 (815) 435-2417		
The Kansas City Southern Railway Company	203	114 W. 11th Kansas City, MO 64105 (816) 556-0303	3,166	MO, KS, AR, OK, LA, TX
Lenawee County Railroad Company, Inc.	200	708 E. Michigan Street Adrian, MI 49221 (517) 263-9544		

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Louisville & Nashville Railroad Co.	3,272	See Seaboard System R.R.	13,579	AL, FL, GA, IL, IN, KY, LA, MS, NC, OH, TN, VA
Maine Central Railroad Company	250	242 St. John Street Portland, ME 04102 (207) 773-4711	1,265	ME, NH, VT
Missouri-Kansas-Texas Railroad Co.	153	Katy Building, 701 Commerce St. Dallas, TX 75202 (214) 651-6706	2,945	MO, KS, OK, TX
Missouri Pacific Railroad Company	3,716	Missouri Pacific Bldg., 210 N. 13th St. St. Louis, MO 63103 (314) 622-0123	20,830	MO, KS, NE, CO, AR, IL, LA, MS, OK, TN, TX, NM
Nashville & Ashland City Railroad Co.	2,500	1451 Elm Hill Pike, Suite 301 Nashville, Tenn 37210 (615) 366-7481		
Nevada Northern Railway Company	2,147	P.O. Box 11248 Salt Lake City, VT 84147		NV
Norfolk and Western Railway Company	2,119	8 North Jefferson St. Roanoke, VA 24042 (703) 981-4000	21,208	VA, WV, MD, NC, KY, OH, PA, NY, IN, IL, MI, MO, IA, NE, KS
Providence and Worcester Railroad Co.	466	One Depot Square Woonsocket, RI 02895 (401) 765-2000	180	CT, MA, RI
Richmond, Fredericksburg and Potomac Railroad Co.	393	2134 West Laburnum Ave. Richmond, VA 23227 (804) 257-3221	884	VA
St. Louis Southwestern Railway Company	473	One Market Plaza San Francisco, CA 94103 (415) 541-1000	5,100(3)	IL, MO, AR, LA, TN, KS, NM, OK, TX
Seaboard Coast Line Railroad Company	205	500 Water Street Jacksonville, FL 32202 (904) 359-3100	20,132	VA, NC, SC, GA, FL, AL
Soo Line Railroad Company	1	Soo Line Building, Box 530 Minneapolis, MN 55440 (612) 332-1261	4,304	MI, WI, MN, ND, SD, MT, IL
Southern Pacific Transportation Company	1,047	One Market Plaza San Francisco, CA 94103 (415) 541-1000	37,000	AR, CA, LA, NV, NM, OR, TX, VT

Transamerica Interway

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Southern Railway Company	6,904	99-125 Spring St., S.W. Atlanta, GA 30303 (404) 529-1000 P.O. Box 1808, Washington, D.C. 20013 (202) 383-4000	20,496	DC, VA, NC, SC, GA, AL, MS, TN, KY, IN, IL
The Texas Mexican Railway Company	297	1200 Washington St. P.O. Box 419 Laredo, TX 78040 (512) 722-6411		TX
Union Pacific Railroad Company	1,456	Union Pacific Building, 1416 Dodge St. Omaha, NE 08179 (402) 281-582[illegible]	28,027	IA, NE, WY, ID, OR, WA, MO, KS, CO, MT, UT, NV, CA
The Western Pacific Railroad Company	1,096	526 Mission St. San Francisco, CA 94105 (415) 982-2100	2,600	CA, NV, UT
Wolfeboro Railroad Company	402 64,601			
Leasing Companies				
Availco Systems	9,700	875 N. Michigan Ave. Suite 3309 Chicago, IL 60611 (312) 787-1817		
K. & M. Leasing Company	72	90 Western Avenue Allston, MA 02134 (617) 782-6000		
Strick Lease, Inc.	1,302	U.S. Highway 1 Fairless Hills, PA 19030 (215) 949-3600		
Transamerica Transportation Services Inc.	31,403*	522 Fifth Avenue New York, NY 10036 (212) 719-9700		
Vermont Railway, Inc.	2,639	Burlington, VT (802) 658-2550		
XTRA, Inc.	37,206** 82,322	60 State St. Boston, MA 02109 (617) 367-7938		

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*Excludes certain marked trailers. Total fleet is approximately 36,000.

**We believe this figure includes OTR trailers. 10K for 1982 lists 28,900 piggyback trailers.

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Water Carriers				
Amiquip Division of Marine Terminals, Inc.	391	P.O. Box 59-3037 AMF Miami, FL 33159 (305) 374-4476	850	
Coordinated Caribbean Transport, Inc.	1,098	1500 Port Blvd., Dodge Island Miami, FL 33132 (305) 358-0505	770	
Matson Navigation Company	194	P.O. Box 3933 San Francisco, CA 94119 (415) 957-4800	1,260	
Puerto Rico Maritime Shipping Authority	2,131	P.O. Box 71306 San Juan, Puerto Rico (809) 783-1414	920	
Totem Ocean Trailer Express, Inc.	1,185	130 Sitcum Waterway Tacoma, WA 98421 (206) 756-9214	170	
Trailer Marine Transport Corporation	4,999	P.O. Box 2110 Jacksonville, FL 32203 (904) 354-0352	450	
Others				
ACME Markets, Inc.	240	124 N. 15th St. Philadelphia, PA 19101 (215) 568-3000		
Cornucopia Transportation, Inc.	67	P.O. Box 157, 622 E. Alisall Street Salinas, CA 93902 (408) 757-5301		
Custom Transportation Systems, Inc.	36	P.O. Box 248 Clarendon Hills, IL 60514 (312) 254-8111		
Fruit Growers Express Company	571	P.O. Box 1672 Washington, D.C 20013		
Gelco Rail Services Company	900	P.O. Box 77932 San Francisco, CA 94107 (415) 986-8400		

Company Name	Number Piggyback Trailers	General Offices	Number of Employees	States of Operation
Holland Cartage Company	80	4625 W. 55th St. Chicago, IL 60632 (312) 581-3400		
MSA-Lamda, Inc.	105	4430 E. Sheila St. Los Angeles, CA 90023 (213) 265-3900		
Transconex, Inc.	15	P.O. Box 524037, 3000 N.W. 74th Ave. Miami, FL 33152 (305) 592-5300		
Union Pacific Fruit Express Co.	2	1416 Dodge St. Omaha, NE 68179 (402) 271-4888		
Yellow Forwarding Co.	8	P.O. Box 490, 2701 Clark Ave. St. Louis, MO 63166 (314) 533-5000		
	2,024			
Total	153,946			

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(1) Owned or long term leased (Rail Markings)—Source: The Official Intermodal Equipment Register, Nov. 1982—Excludes Canadian Railroads.

(2) Moody's Transportation Manual—1982

(3) 1980 Figures

10-19-83

The following companies and organizations have indicated to us their endorsement of S. 1231:

COMPANY	PRINCIPAL LOCATIONS	BUSINESS
Brae Corp.	California & Wisconsin	Trailer Manufacturer Lessor
Miller Trailer	Florida	Trailer Manufacturer
Heritage Trailer	Florida	Trailer Manufacturer
Budd Company	Pennsylvania	Trailer Manufacturer
Lifschultz Fast Freight	New York	ICC Regulated Motor Carrier
Clipper Express	Illinois	Freight Forwarder
Interstate Consolidated	California	Shipper's Agent
Keystone Terminals	New Jersey	Shipper's Agent
Tri-State Consolidators	Pennsylvania	Shipper's Agent
Intermodal Transport	California	Shipper's Agent
Los Angeles Piggyback Service	California	Shipper's Agent
Rapid Traffic Services	California	Shipper's Agent
Bay State Shippers	Massachusetts	Shipper's Agent
American Pacific Forwarder	California	Freight Forwarder
National Association of Shipper's Agent	Washington	Trade Association
Crowley Maritime	California	Steamship Company
Itel Corp. (Itel Rail, Itel Transportation Services)	California	Box Car, Flatcar and Trailer Leasing
Nashville & Ashland City	Tennessee	Railroad
Totem Ocean Express	Washington	Steamship Company
Puerto Rican Maritime	Puerto Rico	Steamship Company
Greater South Traffic	Tennessee	

Concorde Nopal	Florida	Steamship Operator
Burlington Northern RR	Minnesota	Railroad
American Institute for Shippers' Associations	Washington, D.C.	Trade Association
Southern Pacific RR	California	Railroad
XTRA, Inc.	Massachusetts	Piggyback Trailer Lessor
Vanco, Inc.	New Jersey	Trailer Manufacturer
Chicago and Northwestern Transportation Company	Illinois	Railroad
Coordinated Caribbean Transport, Inc.		Steamship Company
Rail Progress Institute	Washington, D.C.	Trade Association

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November 11, 1983

SUPPLEMENTAL STATEMENT OF TRANSAMERICA INTERWAY INC. IN SUPPORT OF S. 1231

At the hearing on S. 1231 held before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, on October 28, 1983, the American Trucking Association, Inc. ("ATA") gave oral testimony that we believe needs clarification.

1. The ATA's logic is confused when it is argued that S. 1231 places over-the-road operators at a competitive disadvantage. The excise tax is one placed only on certain heavy vehicles on the underlying premise that they do more damage to the roads and should therefore pay for that damage through this special asessment. Transamerica Interway has given largely uncontradicted evidence on the low use of the roads by piggyback trailers as compared with over-the-road trailers. The issue is not, therefore, one of competitive advantage or disadvantage, but rather one of fairness - should piggybacks pay the same excise tax as an over-the-road trailer? Clearly the answer is NO.

2. The ATA implies that piggybacks without an excise tax would virtually ride the roads free of charge. Let us not forget that operators of piggybacks in addition to the tire tax must pay the fuel tax on the tractor that pulls the piggyback on the road as well as the user tax and excise tax on the tractor itself. Thus, a piggyback will pay its fair share in proportion to the minimal time it is on the roads.

3. Transamerica Interway believes that a Certification procedure will work. We foresee Treasury regulations that would, for example, require (a) that the piggyback must be built to AAR specifications and so certified by the manufacturer, (b) that it be included in the "Official Intermodal Equipment Register", (c) that it bear Association of American Railroad's assigned reporting marks and (d) that the owner submit a sworn statement that the "principal use" is for piggyback use.

4. We see no reason why truckers owning refrigerated piggyback trailers should not be able to obtain the exemption, the same as any other owner/operator upon appropriate "Certification."

5. We disagree with the over-the-road trailer annual mileage figures used by the ATA. However, even accepting the ATA mileage numbers for over-the-road trailers, the result is not changed -- the magnitude of the difference between 35,000 miles (ATA's number) and our surveys of approximately 1,400 and 2,400 miles for piggyback is still so great as to continue to warrant the exemption.

6. The fact that many other vehicles have low mileage does not argue against the validity of an exemption for piggyback.

##########

In conclusion, we suggest that the case for a piggyback exemption has been made and the ATA's testimony does not change the basic fairness and equity for such an exemption.

STATEMENT OF LANA BATTS, MANAGING DIRECTOR, RESEARCH AND POLICY ANALYSIS DIVISION, AMERICAN TRUCKING ASSOCIATIONS, INC., WASHINGTON, D.C.

Ms. BATTS. Thank you, Mr. Chairman, Senator Boren.

My name is Lana Batts, and I am the managing director for the American Trucking Associations. As you know, we represent all kinds of motor carriers—for hire, private, regulated, non-regulated. And as such, we represent a large number of users of piggyback service. And indeed, we find that this is a significant as well as a growing segment of the motor carrier industry.

We welcome the opportunity to present our ideas on S. 1231, because we believe that many of the provisions that were included in the Surface Transportation Assistance Act were not given full consideration and, particularly, these other taxes appear to have been lost in the shuffle as Congress concentrated on the 5-cent gasoline tax.

As we read S. 1231, we note that it would apply only to certain piggyback trailers which are used principally—underscored—in connection with trailer-on-flatcar service, and that the Secretary of the Treasury will develop regulations which "the seller certifies . . . the manner and form . . . that such trailer . . . will be used, or resold for use, principally in connection with such service. . . ."

Based upon that language, we oppose S. 1231 for six very simple reasons: First, it places over-the-road operations at a competitive disadvantage; second, certification of "principal use" is impossible; third, other highway vehicles have low mileage vehicles; fourth, tax avoidance will become a problem; fifth, piggyback is not as efficient as claimed; and sixth, piggyback is not as safe as claimed.

I would like to specifically address a couple of these items. First, we believe that S. 1231 places over-the-road motor carrier operations at a significant competitive disadvantage. The Surface Transportation Assistant Act raised Federal highway taxes for a five-axle tractor semitrailer from $1,746 per year to almost $4,000 by 1985, and up to $4,300 a year in 1988. This reflects only Federal taxes. Not included are massive increases in State taxes as the States try to match the Federal dollars that are now available.

We have always believed that all highway users should pay their fair share. Passage of S. 1231 would mean that piggyback trailers will not be paying their fair share. Ultimately they will only be paying the tire tax, which will amount to some $24 a year, compared to the tax paid by its competitor, the five-axle tractor semitrailer, of almost $4,000 per year.

The proposed tax exemption would come at a time when the trucking industry is under tremendous financial problems. The trucking industry is just coming out of the worst year it has ever had. It has been paying its fair share of highway taxes. It is going to be paying more.

We think it is interesting to note that while the industry pays income tax, the railroad industry is not paying any income tax; although their profits are much higher than the trucking industry.

We also don't think sellers can certify principal use for piggyback trailers. We have surveyed our members who use piggyback trailers, and they tell us trailers are not dedicated exclusively for piggyback use; they are interchanged within the fleet, and they are interchanged consistently.

Finally, we believe that the weight penalty for manufacturing a piggyback trailer is not that significant for carriers who are not weight-limited. As the table on page 8 in our testimony shows, many carriers would be willing to incur a 1,000-pound empty weight increase to save $800 per trailer.

Senator PACKWOOD. Let me ask you this: Do you think the RoadRailers should have been exempted?

Ms. BATTS. Absolutely not.

Senator PACKWOOD. Even though they are used very little on the highways—if the evidence is to be believed?

Ms. BATTS. As RoadRailers grow, the lengths of haul, or the time that those vehicles are on the highway, is going to expand. If you look at piggyback operations that are taking place—and, interestingly enough, piggyback operations were not significantly affected by the recession—he average lengths of haul, or the time that those trailers are on the road, is expanding. We think that trend will continue to expand, because we support intermodalism.

Senator PACKWOOD. Let me ask you this question: One, you are saying the amount of miles on the road is difficult if not impossible to prove—right?

Ms. BATTS. Correct.

Senator PACKWOOD. If it was provable, should those who use the roads less pay the same as those who use the roads more?

Ms. BATTS. Yes, but we think there are some ways you can respond to the problem. If there is a significant problem and if the excise tax is impeding either the competitiveness of the piggyback trailer with RoadRailer or the growth of that segment of intermodalism, something could be worked out.

One way would be to exempt the incremental cost that it takes to convert a trailer from a regular over-the-road trailer to a piggyback trailer from that excise tax.

Another alternative would be to determine how many miles that trailer is on the road and how many it is on a flatcar. At this point, we have one company's estimate of highway miles. And indeed, if it is only 3,000 miles, there are a number of other vehicles that are averaging those very low mileage that are also exempt—I mean, also paying the tax.

Senator BOREN. When you said also exempt, I think that is an accurate statement, isn't it? Because I know we exempted the agricultural vehicles and others where their onroad use is less than 5,000 miles.

Senator PACKWOOD. What she is saying is that there are a bunch that are not exempt that are on the road less than 3,000 miles.

Senator BOREN. I know. I thought there might have been a Freudian slip at the last there.

But Mr. Chairman, I certainly agree with Ms. Batt's terms of the excessive penalties that were put on the excise tax. In fact, I am a cosponsor of the bill to try to reduce the increases in those burdens. But I do wonder if you would think it woulo be unfair to have the RoadRailer, if they are both operating under 3,000 miles and approximately the same amount, in a different competitive situation than the piggyback.

Ms. **Batts**. Well, again, we don't think that the RoadRailer should have been exempt. The problem that the piggyback industry has, is competing with the RoadRailer. Therefore, the exemption should be removed.

But again, to correct my earlier statement, the farm vehicles under 5,000 miles are exempt from the use tax; they are not exempt from the excise tax.

Senator **Boren**. Well, let me ask this question. I notice in your statement you talk about converting trucks to piggybacks to avoid the tax, that the additional weight of 1,000 pounds plus the cost of upgrading might offset the tax. But in terms of if you are trying to operate those on the road for any length of time, isn't there also a tremendous fuel differential in operating those smaller vehicles that are heavier than you would have if you were operating just a normal trailer designed for on-the-road use?

Ms. **Batts**. There may be a fuel penalty. But again, given the way the companies are operating the piggyback trailers by integrating them into their fleet when they are not using them in piggyback operations, the fuel penalty is not part of the calculations.

If there is a trailer available and the company needs it, whether or not it is a pig trailer, they will use it in over-the-road operations.

Senator **Boren**. Well, if you were going to operate a company, would you operate all piggyback trailers and just run them up and down the roads? Would that be an economical way to operate?

Wouldn't it be true that with a heavier weight and the smaller units, that you would certainly go broke facing competitors that didn't operate a fleet of piggybacks on the highway?

Ms. **Batts**. No. I don't mean to imply that people would buy all pig trailers. I don't think that's what they do.

What I am saving is that if they have some piggyback trailers within their fleet, and if they are not using them for piggyback service that day, they will use them as an over-the-road trailer.

Senator **Boren**. I wonder if I might ask a question of Mr. Finn. I apologize, Mr. Chairman; I know we are going to have to go over for a vote here in just a minute.

Senator **Packwood**. Go right ahead.

Senator **Boren**. I noticed an inconsistency here in the statement of the Treasury earlier. They say we have insufficient evidence to disprove the allegation that we are using piggybacks 3,000 miles or less, on an average. And then they turn right around and say there is ample evidence that many piggyback trailers travel more miles. That is rather an interesting statement, that they have ample evidence to show how much many travel but no evidence to show what the average figure would be. I don't know exactly how that comes out.

But in your statement, as I understand it, you are basing your estimate on what appears to me to be actually the trailer numbers, the speedometer readout, and actual tabulation of miles operated.

Mr. **Finn**. Right.

Senator **Boren**. Is that how you arrived at your estimates?

Mr. **Finn**. Yes, sir. We had hubometers put on certain of our trailers and ran them for a period of time, and then measured the average mileage.

Now, I think the key thing is not whether it is 1,421 miles, which the first survey showed, or 248 point something, whatever it is. The point is, these things travel very much less on the road by the nature of their construction and their use. They are supposed to go on the rail. And whether they go 2,000 miles, 3,000 miles, or 6,000 miles, that is still a substantial difference from the 50,000 to 60,000 miles that our over-the-road trailers and everybody else's long-haul over-the-road trailers do. That's the point.

So we think that if that tax is designed to pay for highway maintenance, then it should be alined to that mileage differential. That is our basic point—plus the RoadRailer point, which of course is valid, too.

And just to comment on that point on the RoadRailer, certainly the RoadRailer should be exempt, because it doesn't go very far on the roads.

Senator BOREN. Mr. Chairman, I know you want to hear one more witness, and the rollcall is starting, so I will withhold further questions. I think I had an opportunity to ask the two main questions on my mind. Thank you.

Senator PACKWOOD. And I have no further questions. Thank you very much.

Ms. BATTS. Thank you.

Mr. FINN. Thank you.

[Ms. Batt's prepared statement follows:]

STATEMENT OF

Lana R. Batts, Managing Director
Research and Policy Analysis Division
American Trucking Associations, Inc.

on

S. 1231

before the

Combined Subcommittees of

Taxation and Debt Management
and
Energy and Agricultural Taxation

of the

Senate Finance Committee

U.S. Senate

October 28, 1983

FULL STATEMENT

I. INTRODUCTION

My name is (Mrs.) Lana R. Batts and I am Managing Director of the Research and Policy Analysis Division of the American Trucking Associations, Inc. (ATA), at 1616 P Street, N.W., Washington, DC 20036. The ATA represents all kinds of motor carriers -- for-hire, private, regulated and exempt. A significant and growing segment of our industry utilizes trailer-on-flatcar, also known as TOFC or piggyback.

We welcome this opportunity to comment on S. 1231, which seeks changes in the Surface Transportation Assistance Act of 1982 (STAA). STAA, passed by Congress during the hectic lame duck session, made many significant changes in the highway taxes paid by the motor carrier industry:

- Fuel taxes increased 125 percent, from 4 cents-per-gallon to 9 cents-per-gallon;
- Tire taxes increased from 9.75 cents-per-pound to as high as 50 cents-per-pound over 90 pounds;
- Heavy vehicle use tax increased 700 percent from a maximum of $240 per year to $1,900 per year in 1988; and
- Excise taxes increased 33 percent, from 10 percent wholesale to 12 percent retail (assuming a 10 percent dealer markup).

Unfortunately, during the lame duck session most of the debate centered on the 5 cent increase in gasoline. The other taxes were lost in the shuffle.

II. AMERICAN TRUCKING ASSOCIATIONS OPPOSE S. 1231

S. 1231 would "exempt certain piggyback trailers and semitrailers" which are used "principally in connection with trailer-on-flatcar service" from the 12 percent retail excise tax (Chapter 31, Subchapter B, Sec. 4051) on new trailers. (Emphasis supplied.) The Treasury Secretary will develop regulations by which "the seller certifies ... the manner and form ... that such trailer or semitrailer ... will be used, or resold for use, principally in connection with such service ...."

The American Trucking Associations oppose S. 1231 for the following reasons:

1. S. 1231 places over-the-road operations at a competitive disadvantage;
2. Certification of "principal use" is impossible;
3. Other highway users have low mileage vehicles;
4. Tax avoidance will become significant;
5. Piggyback is not as efficient as claimed; and
6. Piggyback is not as safe as claimed.

S. 1231 PLACES OVER-THE-ROAD OPERATIONS AT A COMPETITIVE DISADVANTAGE

The Surface Transportation Assistance Act placed the motor carrier industry at a serious competitive disadvantage with the railroads. With one piece of legislation, Federal highway taxes increased from $1,746 per year to $3,973 in 1985 for a five-axle tractor semitrailer. By 1988, these taxes will reach $4,249. These taxes reflect only Federal highway fees. Not included are state highway tax increases which are occurring in order to match Federal funds and expand state rehabilitation programs.

The American Trucking Associations have long been a strong supporter of every highway user paying his fair share of highway taxes. Passage of S. 1231 would mean that one group of highway users -- piggyback -- is not paying its fair share.

Currently, piggyback trailers only pay two taxes: (1) tire tax and (2) excise tax. The average tire tax paid by piggyback trailers could be as low as $24 annually.[1] The average annual excise tax, amortized over 8 years is $246.[2] Should piggyback trailers be exempt from the excise tax, the average annual tax per year would be only $24 compared with the average annual tax for a 5-axle tractor semitrailer of $3,973 in 1985.

Our Nation's economy depends upon competitive and efficient transportation, both intramodally and intermodally. Real cost changes, such as fuel and labor, have occurred over the years which affect the relative costs of trucks and rails and thus their relative competitive positions. The proposed exemption of piggyback trailers from the excise tax would be an artificial cost change affecting competitive advantage to the benefit of the railroads.

The proposed excise tax exemption and competitive benefit to the rail industry could not come at a worse time for the trucking industry. In attempting to cope with both regulatory reform and the recessionary economy, the motor carrier industry has seen its profitability fall annually since

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[1] Eight tires in a dual tandem arrangement, at 91 pounds each ($10.50 + 50¢ = $11 X 8 = $88). Average tire life is 124,000 miles. At 35,000 miles per year -- the average annual miles per regulated motor carrier trailer -- the average annual tax is $24.

[2] $13,925 average F.O.B. factory price of a 40-foot trailer according to DOT's Road User and Property Taxes on Selected Vehicles. Average cost to modify to piggyback trailer is $977, according to Transamerican Interway, Inc. Average dealer markup is 10 percent. Total price: $16,392. Excise tax at 12 percent retail: $1,967.

1977. In 1982, the industry experienced its lowest level of earnings in history with an operating ratio -- operating expenses divided by gross revenues -- of 98.29. From the residual operating income, further outlays were made, for interest expenses on debt and income taxes, among others. The 1982 net income amounted to a profit margin of 0.50 percent, or 50 cents per $100 of revenues.

Further, while the motor carrier industry pays income taxes, the same is not always so for the railroad industry. According to the Joint Committee on Taxation, motor carriers paid the second highest tax rate at 46.1 percent of the twenty-two industries studied. Railroads had an effective tax rate of minus 7.51 percent, even though they had a net profit of $1.7 billion. Over-the-road trucking industries, on the other hand, generated profits of under $800 million but paid $367 million in U.S. income taxes.

Added to the situation are the highway tax increases imbedded in or stemming from STAA, which significantly affect motor carrier outlays for operating taxes and licenses. These increases, when fully in effect in the near term will add 1.12 to 1.39 percentage points to the motor carrier operating ratio and decrease profits commensurately. Had they been fully in effect in 1982, the motor carrier industry would have experienced a loss of 0.62 to 0.89 percent of revenues instead of generating the meager profit level of 0.50 percent of revenues.[1/] Thus, while the virtually profitless motor carrier industry is incurring added highway taxes, the profitable railroad industry is attempting to avoid increased levies on piggyback trailers which are directly competitive with over-the-road motor carrier equipment.

[1/] See attached report, "The Effect of Increased Highway Taxes on Motor Carrier Operating Expenses and Profitability." prepared by the American Trucking Associations, Inc., April 1983.

CERTIFICATION OF "PRINCIPAL USE" FOR PIGGYBACK TRAILERS IS IMPOSSIBLE

One of the major advantages of piggyback is that the container, i.e., the trailer, can be used on a railroad flatcar or the highway. To the average observer, one would not be able to distinguish a piggyback trailer from any other trailer used exclusively on the highway. We have surveyed our members engaged in piggyback operations as well as highway operations and they report that these trailers are not exclusively segregated for piggyback service. They are integrated into the fleet when not in intermodal service.

In fact, many motor carriers are entering into intermodal agreements with railroads in order to expand their markets. Moreover, reportedly the largest user of piggyback service is a regulated motor carrier. According to Railway Age, motor carriers own 21 percent of all refrigerated piggyback trailers utilizing Plan 3.1/

With this interchangeability, there is no way a seller can certify how the trailer will be used after it is purchased.

MANY OTHER HIGHWAY USERS HAVE LOW MILEAGE VEHICLES

Part of the rationale for exempting piggyback trailers is the claim that piggyback trailers average fewer highway miles than over-the-road combinations.2/ This is an irrelevant comparison. The proper highway mileage comparison is over-the-road trailer operations compared with piggyback trailer operations. The Class I and II regulated motor carrier average 80,000

1/ Ron Heimburger, "Plan 3 Operators Push Perishables Traffic," Railway Age, August 30, 1982, pp. 26-27.

2/ Piggyback Trailers: The Case for Exemption from the Federal Excise Tax, Transamerican Interway, Inc., February 1983, p. 2.

miles annually per tractor.[1] Yet, because trailers outnumber power units 2.5 to 1.0, the average miles per trailer is a substantially lower 35,000 miles annually.

Within the regulated motor carrier industry, specific groups have even lower average annual trailer miles. For example, major general freight carriers operating in local service average 1,759 annual miles per trailer and local specialized common carrier operations average 14,139 annual miles per trailer. These figures are far below the average of 35,114 miles per trailer for the ICC-regulated motor carrier industry.

Furthermore, specific industry segments have low average annual miles. Unfortunately, because of the way Truck Inventory and Use Survey (TIUS) collects data on truck use, average annual trailer miles cannot be computed. Nevertheless, TIUS offers some important insight into average annual miles. For example, all gasoline-powered farm vehicles subject to the excise tax average 7,000 miles per year. (See Table I.)

TABLE I

PROFILE OF GASOLINE-POWERED AGRICULTURAL TRUCKS
- 1977 -

Gross Vehicle Weight	Number of Trucks	Vehicle Miles Traveled (000's)	Average Miles Traveled
26,001 - 33,000	91,425	549,299	6,008
33,001 - 40,000	23,821	177,523	7,452
40,001 - 50,000	21,908	210,119	9,591
50,001 - 60,000	5,011	51,726	10,323
60,001 - 80,000	3,176	22,189	6,986
TOTAL	145,341	1,010,856	6,955

SOURCE: 1977 Truck Inventory and Use Survey Data Tape, Transportation Systems Center Version.

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[1] 1981 Motor Carrier Annual Report, American Trucking Associations, Inc. 1981.

Unfortunately, the TIUS data presented in Table I is average mean miles, and does not indicate how many farm trucks average less than 10,000 miles per year. The Department of Transportation (DOT) has estimated that 35,000 farm vehicles over 33,000 pounds gross vehicle weight (gvw) average less than 10,000 miles per year. While the excise tax is applicable at 26,000 pounds for trailers and the data are not directly applicable, they do provide some insight into the magnitude of low mileage vehicles traveling the nation's public highways that pay the excise tax. Piggyback trailers are not unique.

TAX AVOIDANCE WILL BECOME SIGNIFICANT

Currently, the excise tax applies to the following five categories of vehicles:

1. All tractors;
2. All truck bodies over 33,000 pounds gvw;
3. All truck chassis over 33,000 pounds gvw;
4. All trailer bodies over 26,000 pounds gvw; and
5. All trailer chassis over 26,000 pounds gvw.

If certain trailers over 26,000 pounds gvw are exempt, then it will be fairly easy for many trailers to be exempt. As indicated in Table II, a carrier could save $766 by claiming to have a trailer used principally in trailer-on-flatcar service. Any carrier not weight limited would find it advantageous to incur a 1,138 pound empty weight increase to save $766 per trailer.

TABLE II

COMPARISON OF COSTS

Under S. 1231

	Piggyback Trailer	Regular Trailer
COST OF TRAILER F.O.B. Factory[1]	$13,925	$13,925
COST OF MODIFICATION[2]	977	N/A
Subtotal	$14,902	$13,925
10% Dealer Markup	1,490	1,395
Subtotal	$16,392	$15,320
Excise at 12% Retail	N/A	1,838
TOTAL	$16,392	$17,158
Added Weight Per Trailer[2]	1,138 pounds	N/A

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[1] Department of Transportation's Road User and Property Taxes on Selected Motor Vehicles (1982), Table I, p. 13.

[2] Piggyback Trailers: The Case for Exemption from the Federal Excise Tax, Transamerican Interway, Inc., February 1983, Appendix VII.

N/A = Not Applicable

PIGGYBACK NOT AS EFFICIENT AS CLAIMED

Another argument used to support an exemption for piggyback trailers is that they are three times more fuel efficient than standard over-the-road operations.[1] Yet, depending upon what kind of service is being considered, there can be no fuel advantage to piggyback at all. (See Table III.)

Since 1980, relative energy efficiency studies measure energy consumption for comparable transportation movements. The results of these studies offer conclusive evidence that no one mode can be considered inherently more energy efficient than another.

For example, the Department of Energy (DOE) devised a demonstration study to measure energy efficiency and concluded:

> simply dividing the total amount of fuel that the railroads consume in a year into the total number of ton-miles moved and comparing the results with a number similarly derived for intercity truck freight transportation is not realistic. Instead, a true comparison can only be obtained when the modes concerned transport freight between the same origination and destination points. 2/

After conducting an investigation of relative energy efficiency, the Association of American Railroads concluded it could not support blanket statements about energy efficiency:

> The main point of the analysis is that service type is extremely important when evaluating energy efficiency. Simple statements such as "rail is more energy efficient than truck" or "barges are more energy efficient than rail are misleading." Relative modal energy efficiencies can vary depending on what kind of transportation service is being analyzed. (Emphasis supplied.) 3/

1/ Piggyback Trailers, op. cit., Appendix IV.

2/ Press Release by Sydney D. Berwager, Office of Conservation and Solar Applications, Department of Energy, January 1980.

3/ David S. Paxson, Association of American Railroads, "The Energy Crisis and Intermodal Competition," Transportation Research Record 758, 1980, pp. 89-92.

TABLE III

RELATIVE ENERGY EFFICIENCY ESTIMATES

MODE	NET TON-MILES PER GALLON
TRUCK	
Department of Energy 1/	87
Association of American Railroads 2/	105
American Trucking Associations 3/	107
SRI International 4/	107
Department of Transportation 5/	174
RAIL	
Department of Energy 1/	173
Association of American Railroads	
Long Haul 2/	173
Short Haul 2/	97
SRI International 4/	147

SOURCE: 1/ Press Release by Sydney D. Berwager, Office of Conservation and Solar Applications, Department of Energy, January 8, 1980, 45-foot highway trailer, 40-foot piggyback trailer.

2/ David S. Paxson, Association of American Railroads, "The Energy Crisis and Intermodal Competition," Transportation Research Record 758, 1980, pp. 88-92. Twenty-five ton payload, 90 percent loaded miles.

3/ Lana R. Batts, Truck/Rail Comparative Fuel Efficiency, Technical Report (TSW-81-12), American Trucking Associations, Inc., 1981, p. 44.

4/ Patrick J. Martin, "Truck and Rail Energy Comparisons," by SRI International, Menlo Park, CA, a Presentation to the 5th Western Highway Institute/Motor Vehicle Manufacturers Association Research Symposium, October 9-10, 1980, San Francisco, CA, p. 15, A.

5/ Computed from data provided by Harry Close, Voluntary Truck and Bus Fuel Economy Program, Department of Transportation, "Voluntary Truck and Bus Energy Conservation Works in the United States," Speech Before Commercial Motor Energy Conservation Conference, Goodwin, England, May 29, 1980, p. 11. State of the art fuel efficient vehicle.

Finally, SRI International not only looked at past energy efficiency but also potential improvements in locomotive and truck tractor fuel usage. In addition, SRI then went one step further to determine the value added to commodities or merchandise per unit of energy consumed because in an energy short economy, the U.S. "should strive to add maximum value per unit of energy used, rather than add maximum distance per unit of energy used." SRI concludes

> trucks offer more value added per gallon than rail. The total system and general freight group show very significant advantage for trucks. [1]

PIGGYBACK NOT AS SAFE AS CLAIMED

Proponents of S. 1231 claim piggyback is 1,392 times safer than over-the-road[2] traffic because it has .01 fatalities per ton-mile compared with 19.76 fatalities per ton-mile for over-the-road trailers. Their analysis and conclusions are seriously flawed for several reasons:

1. Fatality rates are usually calculated using vehicle miles as the denominator, not ton-miles. Introducing ton-miles artifically inflates the safety record of piggyback; piggyback carries more tons per train than over-the-road carriers can per truck so the denominator of the railroad fatality rate is artifically high and the rate itself is, therefore, artifically low. Using vehicle miles only would lower the heavy truck fatality rate and raise the railroad rate making them far more similar than they appear now.

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[1] Patrick J. Martin, "Truck and Rail Energy Comparisons," by SRI International, Menlo Park, CA, a Presentation to the 5th Western Highway Institute/Motor Vehicle Manufacturers Association Research Symposium, October 9-10, 1980, San Francisco, CA.

[2] *Piggyback Trailers*, *op. cit.*, Appendix IV.

2. The data base on fatalities are very misleading. "Fatalities" could mean "heavy truck occupant fatalities," "other vehicle fatalities in heavy truck-involved accidents," "nonoccupant fatalities in heavy truck-involved accidents," or some combination of the three. The proponents of S. 1231 fail to state explicitly their data categories or their sources for the "heavy truck" fatality figures of 4,642 (1980) and 4,756 (1981). The only similar published figures that could be found were about 5 percent lower: 4,412 for 1980 and 4,496 for 1981 for "number of fatalities in combination truck-related accidents" from Table III-11, page III-18 (based on FARS data) in NHTSA's 1982 Large Truck Accident Causation report (LTAC). FARS annual publications do not break out figures for "number of fatalities in heavy truck-involved accidents:" information obtained by phone from NHTSA's FARS offices indicates those figures to be 4,821 for 1980 and 4,884 for 1981 (3 - 4 percent higher than the proponents' figures). (The figure for 1982 is 4,457 showing an 8.7 percent decrease from 1981.)

   Railroad fatality data also appear to differ from published information. The data used for railroad fatalities (29 and 13) seem too low compared with published NTSB intercity railroad fatalities (employees and pedestrians) of 576 (1980) and 552 (1981), even realizing that the proponents' figures must have been for a subcategory of intercity railroad data (piggyback).

   The proponents used pseudo-specific phrases like "incidence of fatalities involving heavy trucks," but what do they really mean? Their category names and their fatality data do not coincide with published information. If the proponents of S. 1231 are using accurate data, why don't they explicitly state the category of fatality data and their data source so there will be no chance for reader confusion? As cited, the figures used by proponents of S. 1231 are untraceable and can't be confirmed.

3. The comparison does not reflect the full trip for piggyback operations. Some accidents must have occurred to piggyback units being hauled over the road from origin to railhead or from railhead to destination. Including those accidents would not only raise the railroad figures but would decrease the heavy truck figures, since the piggyback-related fatalities are now reflected there.

III. ALTERNATIVES TO THE TAX INEQUITIES OF SURFACE TRANSPORTATION ASSISTANCE ACT

As indicated earlier, the Surface Transportation Assistance Act dramatically changed the highway user taxes paid by motor carriers. The most dramatic change was not the 33 percent in the excise tax (10 percent wholesale to 12 percent retail); rather, it was the 700 percent increase in the Heavy Vehicle Use Tax ($240 maximum to $1,900). Ironically, while the Senate had voted 96 to 1 for a $1,200 maximum and the House for $2,000, the Conference committee "compromised" at $1,900. This tax is even more onerous because it is paid every year regardless of whether the vehicle travels 5,001 miles or 150,001 miles per year.

S. 1475

The trucking industry supports S. 1475, which was introduced by Senator Malcolm Wallop and cosponsored by 22 other Senators. This legislation would eliminate the Heavy Vehicle Use Tax and replace it with a phased-in diesel differential applied to the diesel fuel used by trucks over 10,000 pounds gvw. A comparable bill in the House, H.R. 2124, currently has 193 cosponsors. Moreover, S. 1475 is revenue neutral, raising $71.6 billion compared to $72.0 billion for STAA over six years. Finally, it is a pay-as-you-go system.

REPEAL ROADRAILER EXEMPTION

The reason some piggyback trailer owners want an exemption is not because piggyback is suffering financially. In fact, piggyback traffic was not particularly affected by the recession. Rather, the reason piggyback operators are seeking an exemption from the excise tax is because of the exemption given to Roadrailer units in STAA.[1][2] This exemption was not fully evaluated by Congress in consideration of the legislation. Roadrailer, like conventional piggyback, offers the flexibility of rail or highway use. Like piggyback, Roadrailer is used on highways. Therefore, it should be subject to highway user fees. We urge that the Roadrailer exemption be repealed.

EXCISE EXEMPTION FOR CONVERSION COSTS

Recognizing that piggyback trailers are not used solely on the Nation's highways, some modification of the excise tax structure may be justified. For example, it costs approximately $977 to modify a regular over-the-road trailer for use as a piggyback trailer. (See Table II.) This incremental cost could be exempt from the excise tax. Another possibility might be to grant an exemption to off highway use of piggybacks. We would be willing to further explore either of these possibilities with the proponents of S.1231 and the Committee.

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[1] Piggyback Trailers, op. cit., p. 5.

[2] Sec. 512 "(c)(3)" (8).

IV. CONCLUSIONS

The American trucking industry believes all highway users should pay their fair share of highway taxes. Piggyback trailers, by their very nature, are used on highways and should pay highway user fees. Congress should not be expanding the number of exemptions to the Highway Trust Fund at a time when revenues are desperately needed.

Moreover, the trucking industry is deeply disturbed by the type of arguments used by the proponents of the exemption from the excise tax. Rather than emphasizing the positive aspects of piggyback and the increasing cooperation between railroads and motor carriers to promote piggyback, the proponents of S.1231 attack the trucking industry as fuel inefficient, unsafe and polluting. They urge Congress to get as many trailers off the highways and on to the rails.1/

The American trucking industry supports intermodalism and piggyback. We believe every mode or combination of modes should be allowed to exercise its inherent advantage. Furthermore, the trucking industry supports efforts to improve intermodalism. However, this improvement cannot come at the expense of either mode. S.1231 seeks to improve intermodalism at motor carrier expense by creating an artificial cost advantage. ATA stands ready to work with the Committee, however, to develop an alternative to S.1231 which would solve the problems of its proponents while protecting the Highway Trust Fund, and at the same time fostering the growth of intermodalism.

1/ Ibid., p. 3.

Senator **Packwood**. We will conclude with Daniel Brennan, the vice president for taxes and insurance, Consolidated Foods, on S. 1807.

Mr. Brennan, let me assure you that you have a very enthusiastic champion in Senator Percy. He has talked to me about this bill several times and about your particular situation several times.

Mr. **Brennan**. Thank you. I am very happy to hear about that, Mr. Chairman.

STATEMENT OF DANIEL J. BRENNAN, VICE PRESIDENT, TAXES AND INSURANCE, CONSOLIDATED FOODS CORP., CHICAGO, ILL.

Mr. **Brennan**. Let me just explain that I represent Consolidated Foods, which is a large consumer package goods company headquartered in Chicago. Around the world we employ about 93,000 employees.

In 1968 Consolidated Foods bought a 65 percent interest in a publicly traded Dutch coffee trading company. The sales of the company were about $1 billion, and they continue to be at that level.

The company, called Douwe Egberts, was founded in 1753. In addition, there is a subsidiary in Switzerland that was founded in 1969. This subsidiary was set up in order to trade coffee. Switzerland happens to be one of the largest coffee trading centers in the world, where about 25 percent of the coffee is traded.

Now, the Swiss company pays dividends in normal commerce to its parent in Holland. When the parent receives the dividends in Holland it is not subject to Dutch tax, under the Dutch tax rules.

Normally, the subpart F rules of our Internal Revenue Code would say that those dividends are subject to subpart F rules and therefore we would have to pay a tax on 65 percent of the income, because we own 65 percent of the company.

Now, there is an exception in section 954(b)(4) that says: if neither the acquisition of the company—in our case, Douwe Egberts—nor the payment of the dividend from Switzerland to Holland was done for tax-avoidance purposes, the exception should apply.

Senator **Packwood**. Let me ask you this. Would this bill affect any other company but yours?

Mr. **Brennan**. Not that we know of, Senator.

Senator **Packwood**. I see nothing wrong with special legislation if the equities are on the side of the company for which you are trying to pass the legislation.

Often people will say, "Well, this is a bill that affects only one company," as if the presumption is, "Therefore, it is bad or immoral." I don't share that. I just wanted to make sure that to the best of your knowledge no one else is in the same situation.

Mr. **Brennan**. I can't tell that, Senator. Senator, what we are looking for here is, this bill is a clarification. It is not an extension.

Senator **Packwood**. No; it is a clarification of what you assume to be the law, and I think probably correctly assume to be the law.

Mr. **Brennan**. Absolutely correct, Senator.

What we are asking for here is just a clarification to allow us to do something that we feel the law already says.

Senator **Packwood**. And you heard my question to Treasury this morning.

Mr. **Brennan**. Yes.

Senator **Packwood**. I found their answer rather specious, frankly. They were giving an answer—one, I am not even sure it was relevant to this bill, because this bill is so narrowly confined. I am not sure they knew that. But I think they were imagining horrors beyond anything possible this bill could allow.

Mr. **Brennan**. That is the end of my comments, Senator.

[Mr. Brennan's prepared statement follows:]

STATEMENT OF DANIEL J. BRENNAN

BEFORE THE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

MR. CHAIRMAN and members of the Subcommittee, I am DANIEL J. BRENNAN, Vice President - Taxes & Insurance of Consolidated Foods Corporation, a Chicago-based company which is primarily engaged in providing consumer-packaged goods to the public. I am pleased today to have an opportunity to comment on S. 1807 introduced by Senators Charles Percy and Alan Dixon. This bill clarifies an exception regarding "Subpart F" income.

Present Law -- Under present law, the earnings of foreign corporations owned or controlled by U.S. persons are generally subject to U.S. income tax only when they are actually remitted to the U.S. shareholders as dividends. This treatment is normally referred to as "deferral."

In 1962, in response to a request by President Kennedy, Congress enacted partial repeal of "deferral" by what is commonly referred to as "Subpart F" in the tax law. At that time, the President requested the removal of tax deferral for income generated by what have been called "tax havens." Tax havens were being used by American firms who arranged their corporate structures to significantly reduce or eliminate their tax liabilities both at home and abroad. Therefore, certain parts of the Subpart F rules were adopted in order to meet the problem of diversion of income from U.S. taxation.

There are now five categories of "Subpart F" income. If a controlled foreign corporation generates "Subpart F" income, such income is deemed to be a dividend to the U.S. shareholder. Under these rules U.S. tax is due even though no dividend is declared and no cash in received by the U.S. shareholder.

One Subpart F income category covers passive investment income such as dividends, interest, royalties, and rents (generally referred to as foreign personal holding company income). It is an exception to this category that S. 1807 clarifies.

In 1969, the Internal Revenue Code was amended to broaden and clarify one exception. By amending Section 954(b)(4), an item of income received by a controlled foreign corporation was excluded from treatment as foreign personal holding company income if neither the creation or acquisition of the controlled foreign corporation nor the effecting of the transaction giving rise to the income had as one of its principal purposes a substantial reduction of income taxes. The rationale behind this exception was the facts and circumstances should prevail where tax avoidance is not a significant motivating force in the transaction.

Later, the tax Reduction Act of 1975 adopted an exclusion to the taxation provisions of Subpart F for income arising from the sale between related parties of agricultural commodities which are not grown in the U.S. in commercially marketable quantities. The rationale of that amendment was that since the activity could not have been performed in the U.S., (because the commodities were not grown in commercially marketable quantities here) then no avoidance of U.S. taxation could be involved. So, there is a history of granting exceptions where inequities could be shown.

CONSOLIDATED FOODS CORPORATION'S OPERATIONS ABROAD

Consolidated Foods Corporation owns a 65% interest in a company, Douwe Egberts Koninklijke Tabaksfabriek-Koffiebranderijen - Theehandel, B.V., which is incorporated in the Netherlands. Douwe Egberts is a large multi-national company which has been in existence for centuries. To be precise, it was founded in 1753. Consolidated Foods purchased its interest in 1978 in order to penetrate the European markets with its domestic products.

Douwe Egberts trades in consumer products such as tobacco, tea, coffee, spirits, etc. Among its many subsidiaries is a wholly-owned company in Switzerland.

The Swiss subsidiary is a major international coffee trading operation. It buys from any number of coffee growing companies and sells not only to its sister companies around the world, but also to unrelated parties. It is of interest that Switzerland is one of the major international coffee trading centers in the world. The income generated in Switzerland is exempt from taxation as Subpart F income because coffee is not grown in commercially marketable quantities in the U.S. Now, this exemption would apply whether Douwe Egberts earned the income by performing the coffee trading either through a branch or through a subsidiary in Switzerland. However, if the Swiss coffee trading subsidiary declares a dividend (from its coffee earnings) to its parent company in Holland, the present U.S. tax law would, but for the exception noted above, treat the income in Douwe Egberts' hands under "Subpart F" not as exempt coffee income, but as taxable dividend income. This anomally occurs because dividends, whether from subsidiaries or from unrelated companies, are currently deemed by the Internal Revenue Code to be foreign personal holding company income.

At the time of the acquisition of Douwe Egberts, we had been of the opinion, as was our tax counsel, that a dividend from Switzerland to Holland would be exempt from Subpart F treatment under Section 954(b)(4). By operation of the Code, we were required to seek a ruling that said dividends are not "Subpart F" income. The I.R.S. refused to so rule, apparently under the theory that there was no outside compulsion to pay dividends. The I.R.S. position has the effect of treating Douwe Egberts as having been acquired or structured for significant tax avoidance purposes.

This appears to us to be a strange and unduly restrictive interpretation of the statute, especially since Douwe Egberts was founded in 1753, and dividends had been paid from Switzerland to Holland for a number of years prior to our acquisition. We at Consolidated Foods believe the I.R.S. interpretation produces an inequity, this bill, in essence, redresses that interpretation, which we believe is erroneous.

It should be noted that the Dutch tax authorities insist upon the payment of such a dividend to preclude Douwe Egberts from borrowing to fund its business operations and deducting the interest for Dutch Tax purposes. Douwe Egberts is hard pressed to argue that if a dividend is paid, significant tax ramifications occur to its parent under the U.S. "Subpart F" rules. It should be further noted that the funds are used, in part, to pay a cash dividend of approximately 40% of earnings, to its shareholders, 65% of which dividends are received by ConFoods.

To sum up, the spirit of U.S. tax policy is not being circumvented by the bill, and no U.S. tax is being avoided. Nonetheless, the impact of the law is that Douwe Egberts and Consolidated Foods have been placed in a severe competitive disadvantage in trying to run their European operations.

We believe that the current situation is inequitable, and that the correction of this situation will not in any way adversely affect the operation of the policies incorporated in Subpart F.

Thank you, Mr. Chairman and members of the Subcommittee for giving me the opportunity to appear before you to express our views.

Senator **Packwood**. And with that, I am going to adjourn the hearing and go vote. I hope that I don't miss it.

Thank you for waiting.

Mr. **Brennan**. Thank you very much.

Senator **Packwood**. You are very welcome.

[Whereupon, at 11:15 a.m., the hearing was concluded.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

HENRY J. NOWAK, N.Y.
CHAIRMAN

BUDDY ROEMER, LA.
TOM J. VANDERGRIFF, TEX.
C. ROBIN BRITT, N.C.
DENNIS E. ECKART, OHIO
JAMES R. "JIM" OLIN, VA.

United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Access to
Equity Capital and Business Opportunities
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October 28, 1983

Honorable Bob Packwood
Chairman, Subcommittee on
Taxation and Debt Management
Senate Finance Committee
SD 219 Senate Office Building
Washington, D. C.

Dear Mr. Chairman:

This is in regard to today's hearing on S. 842, the Small Business Participating Debenture legislation, as introduced by Senator Lowell Weicker. SBPDs are a most important capital formation tool, especially at a time when real interest rates have reached historical highs. The companion bills in the House (of which I am a cosponsor) have been introduced by Dennis Eckart (H.R. 1136) and Dan Marriott (H.R. 1902).

Your hearing is being conducted at a most significant time in our Nation's history. While our economy is coming out of its deepest recession since the Great Depression, the current recovery is one of the most unbalanced in memory. Many sectors of the economy, including small business, are not greatly benefitting from the initial stages of the recovery. This is due largely to a lack of consistency in the country's monetary and tax policies of the last several years.

The Economic Recovery Tax Act of 1981, as signed into law by the President, primarily benefitted large capital intensive firms. In contrast, small business received only a small measure of relief from the 1981 tax cut.

The SBPD legislation would contribute to a reversal of this situation and, thus, add more balance and equity to the Tax Code. More significantly, the measure would provide small and medium sized firms with an increase in capital, which is so critical to business expansion and investment. Accordingly, SBPDs should be considered an important component of any small business capital formation agenda developed by the Congress.

I commend you on your timely hearing.

Sincerely,

Henry J. Nowak
Chairman

AMERICAN ASSOCIATION OF MESBICs

American Association of
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Small Business
Investment Companies

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Chairman of the Board
E PATRIC JONES
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Chicago Illinois

November 29, 1983

Senator Bob Packwood, Chairman
Subcommittee on Taxation and Debt
Management Committee on Finance
United States Senate
SD-219 Dirksen Senate Office Bldg.
Washington, D. C. 20510

Dear Chairman Packwood:

The American Association of Minority Enterprise Small Business Investment Companies (AAMESBIC) appreciates the opportunity to submit this statement in conjunction with your Subcommittee's October 28, 1983 hearings on S.842.

MESBICs, also known as 301(d) SBICs, are authorized under the Small Business Investment Act of 1958, as amended, to provide a unique public/private sector partnership which utilizes a base of dollars. This greatly increases the pool of capital available to minority owned businesses.

By the end of 1982, there were 127 MESBICs with total private capital of $121 million and total SBA leverage of $165 million, for a total capital figure of $286 million. During 1982, MESBICs invested $47 million in 629 small businesses. In addition, those small businesses created or maintained approximately 7,500 jobs.

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Small business in general has been playing an increasingly important role in the American economy, offering significant contributions in two vital areas; job creation and innovation. Recent studies have indicated that approximately 75% of all new jobs in America are created by small businesses. Just last year the problem of unemployment reached record levels. Unfortunately, this problem occurred at the same time many small businesses were failing due to high interest rates and inaccessability to capital. The prohibitively high interest rates offered through conventional lending sources and the unwillingness of other investors to provide venture capital to these small concerns caused many of the companies to cease operations. Thus, the major source of new jobs was diminishing at the same time those jobs were most needed.

Small businesses are also a major source of innovation. At a time when America appears to be losing its technological advantage over other countries, and is consequently losing vital markets to those countries, in the international market arena, it seems particularly advantageous to encourage those businesses that are offering innovative achievements. One recent study showed that small firms produce 25 times as many innovations as large firms, relative to the number of people employed. The study also found that the time necessary to bring an innovation to market averaged 2.22 years for small firms, compared with 3.05 years for large firms.

With small businesses making such important contributions to the economy, it seems reasonable to ask why the inadequacy of viable financing vehicles has been tolerated for so long. Surely such vital interests deserve the support of both the private and public sectors in our economy. Yet, with the exception of a few programs, this has not been the case. Small business entrepreneurs continue to face a shortage of source of institutional capital.

This past summer the Association participated in forums held by the Securities and Exchange Commission's Executive Board for Small Business Capital Formation. The forums offered small business entrepreneurs and organizations the opportunity to testify before the Board and outline the special needs of small businesses, as well as propose possible solutions to those problems. Time and again we listened to witnesses express their concern over the lack of a source of institutional capital for smaller businesses. In many cases, a small business entrepreneur must turn to his or her family sources in order to obtain the vital seed capital that more conventional are unable or unwilling to provide. However, even this last resort is unavailable to many individuals who simply do not have sufficient family resources from which to draw.

AAMESBIC therefore seeks the establishment of a Small Business Participating Debenture (SBPD). We have supported the concept since our participation in the White House Conference on Small Business, during which the SBPD was offered as a priority item, and we continue to support it in S.842.

The SBPD, as proposed, would offer elements of both equity and debt capital that would be attractive to small businesses seeking investors. Similar to debt capital, SBPD's would be issued by eligible firms for a stated rate of interest negotiated by the borrower and lender. The interest rate on the SBPD would be lower than that on conventional loans, however, due to the equity element of the instrument. In addition to paying out a stated rate of interest on the SBPD, the small business concern would provide the investor with a negotiated share of profits during the period the instrument is outstanding. Payments of both stated interest and the profit participation element would be deductible by the issuing company. However, in contrast to stock warrants and rights, which effectively allow investors to participate in earnings beyond the period during which their investments are repaid, the holder of an SBPD would have no voice in the operation of the company other than the right to participate to a limited extent in its profits until the capital has been repaid.

The proposed SBPD also offers several elements attractive to investors. The investor's earnings from his investment in the business would receive capital gains tax treatment. Additionally, the fixed maturity of the instrument would provide the investor with a fixed date for the recapture of his principle.

As a proposal addressing the needs of both small business entrepreneurs and potential investors in small business concerns, the Association strongly supports the passage of S.842.

Sincerely,

JoAnn Price

JoAnn Price
President

JAP/mg

Statement of the Burlington Northern Railroad
Piggyback Excise Exemption Bill (S-1231)
October 28, 1983

The Burlington Northern Railroad supports Senate Bill S-1231, and believes that enactment is in the public interest.

Passage of the Surface Transportation Assistance Act of 1982, earlier this year, marked an important step in converting sound transportation policy into an equitable and sensible transportation program. In recognizing that those who benefit from the common use of our nation's highways must contribute to its upkeep according to individual use, the Congress created a responsible system to ensure the survival and growth of that network.

Consistent with this theme of cost responsibility, the Congress properly waived the application of the 12 percent excise tax on RoadRailer vehicles, thereby acknowledging the preponderance of their movements by rail instead of by roadway. This provision was not required as an incentive for development of new technology, (the technology has been proved and is in commercial operation) it was a matter of plain fairness.

The 1982 legislation overlooked another system whose use of the highway is greatly exceeded by its time in transit on the rails: the Trailer on Flatcar (TOFC) or piggyback trailer. While the TOFC concept and RoadRailer are quite different conceptually, they are virtually identical in respect to their movement over the railroad relative to their use of the highway. For this important transportation legislation to be fully equitable and to encourage development of the most efficient modes of transport, this oversight must be corrected.

Over the coming 15 years, Burlington Northern Railroad intends to add to its TOFC fleet at the rate of nearly 1500 new trailers per year. They will be hauled on streets and highways by tractors that pay the full amount of the fuel tax and the annual heavy use tax mandated by the 1982 Act for the privilege of using the public facilities. This is as it should be.

These trailers, however, will spend about 90% of their service time on rail cars. In effect, they will be reducing highway congestion and wear to the benefit of other vehicles. Piggyback trailers simply should not be required to pay the same excise tax as a vehicle that uses the highway network ten times as much.

We are grateful for the opportunity to register our views on this issue.

1301 Welton Street
Denver, Colorado 80204
(303) 534-3211

**Denver
Chamber of
Commerce**

November 4, 1983

Mr. Roderick De Arment
Chief Counsel and Staff Director
Senate Finance Committee
219 Dirkson Senate Office Building
Washington, D.C. 20510

Dear Mr. De Arment:

STATEMENT TO BE INCLUDED IN HEARING RECORD OF 10/28 BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT REGARDING S.842 - SMALL BUSINESS PARTICIPATING DEBENTURE LEGISLATION

The Denver Chamber of Commerce represents over 3,000 businesses in the Denver Metropolitan area. Almost 70% of these firms are categorized as small business. This communication is to encourage support of S.842 on Small Business Participating Debentures.

Capital formation and retention is one of small business's biggest problems today. High interest rates particularly penalize small business as they are much more dependent on banks and short-term lending than larger businesses that have access to public markets for capital and long-term debt.

There are many ideas being proposed to help small business generate and retain additional capital in order to maintain and expand their businesses. It is a well-known fact that the majority of new employment comes from the small business sector; consequently, it is even more imperative today to assist the small business person in order to encourage ne[illegible] employment.

One particular idea that we feel has much merit is the Small Business Participating Debenture as embodied in S.842. The SBPD was originally introduced several years ago as a result of the White House Conference on Small Business. Out of the hundreds of issues that were discussed and debated, SBPD's generated such widespread support among small business people that overall it was voted the #9 priority issue.

The most important sources of funds in the past have been commercial banks; but with the gradual disappearance of the small, locally owned and managed bank, these funds have become less available. Large, structured banks are far less likely to finance closely-held companies under the same conditions that were satisfactory to their owner-managed predecessors.

More and more of the Nation's wealth is being accumulated by insurance companies, pension benefit trusts, and other similar institutions. Regulations and traditional investment habits prevent these funds from being directed toward risk situations. In fact, even low risk situations, if they involve small businesses, are generally not acceptable as investments in the institutional marketplace.

The motivation for a traditional investor to direct his funds toward small business has been greatly undermined in recent years. If the investor favors the role of lender, incredibly high interest rates must be charged to warrant the additional risk taken compared to money market funds or similar investments. Whatever interest rate is earned, however, will be subject to ordinary income tax rates; and if the investment is bad, the capital loss incurred will have relatively little tax benefit to offset the economic loss.

On the other hand, should an investor desire to purchase equity there are only a couple of methods to use to realize a fair return on the investment: the equities can be made "liquid" by a sale of the company or a public issue (neither of which may be in the company's best interest and over which the investor may have no control); or being penalized by the prohibitive double taxation on dividends.

There are a limited number of private venture capitalists. Those that do commit capital to emerging businesses traditionally finance only higher risk situations with a potential for extraordinary growth, not traditional expansion. In many instances, a substantial amount of equity and control must be given to the venture capitalist in order to secure this financing. Many firms' owners find these conditions unacceptable.

So, what is needed is a new instrument for financing small businesses which will provide a fair, liquid return on an investment, but without the concomitant need for an "equity kicker" to realize a capital gain.

The SBPD is a concept that will provide the much needed new source of capital for small business.

The advantages to the lender would be that the stated interest paid by the borrowing business would be taxed as ordinary income but the lender's share of the borrowing business's profits would be taxed at the preferential capital gains rate. The lender would also be entitled to deduct any losses as ordinary losses instead of a capital loss.

In addition, under several of the proposed bills, the lender would be entitled to investment tax credits with the credit being limited to a certain maximum amount. The preferential tax treatment discussed above would be lost if the SBPD is disposed of prematurely.

For the borrowing small business, both the stated rate of interest as well as the negotiated percent of the profits would be deductible as an ordinary and necessary business expense. The obtaining of capital though the SBPD would not require giving up a share of the business to an outsider; in addition, the SBPD would be administered between the borrowing business and the lender with no additional government red tape involved.

An additional advantage is the likelihood that there would be no actual net cost to the Treasury, that such investment would begin a cycle of activity that would generate capital investment and new jobs thereby creating more Federal revenues.

The concept of the small business participating debenture would definitely encourage the flow of equity captial and long-term loan funds to small business. The Small Business Council of the Denver Chamber of Commerce strongly urges the Senate Finance Sub-Committee on Taxation and Debt Management to favorably report S.842 to the full committee.

Sincerely,

Richard C. Ten Eyck

Richard C. Ten Eyck
Chairman
Small Business Council

RCT:cb

COMMENTS OF TRUDY A. ERNST, ESQ.
TO THE SENATE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
ON S.1914
"THE HOME EQUITY CONVERSIONS ACT OF 1983"
November 10, 1983

These comments support passage of a revised version of S.1914, which would establish a safe harbor for the tax treatment of certain sale-leaseback home equity conversions by senior citizens.

These comments consist of three parts. The first, a narrative, will largely be responsive to the statement of Robert G. Woodward, Tax Legislative Counsel, Department of the Treasury, before the Subcommittee on October 28, 1983. The second consists of a revised version of S.1914 and the third of individual comments explaining the revisions.

The revised version of the bill was generated jointly by Ken Scholen, Director of the National Center for Home Equity Conversion, Maurice Weinrobe, Associate Professor of Economics, Clark University, and me. Additions to and deletions from the present version of the bill are indicated by underlining and carets, respectively. Certain of the revisions are responsive to Mr. Woodward's statement and certain are responsive to other aspects of these transactions that we believe are important.

I. NARRATIVE COMMENTS

I believe that the revised version of S.1914 is much closer to existing law than S.1914 as proposed, with the exception of Section 8. Thus, rather than creating new tax treatment for these transactions, I believe the bill largely confirms the availability of tax treatment that properly would be given to these transactions without the legislation.

In considering the effects of S.1914, some speculation as to the alternatives to a home equity conversion for both parties to the transaction is appropriate. For the prospective senior seller-lessee, the alternatives are to sell the home and move into other rental housing or to continue to live in the home at whatever standard of living his or her other income and assets will permit. If the senior sells the home and moves to other rental property, the other rental property may or may not be more amenable to the senior's residential needs, and the rent of the alternative residence may or may not continue to be affordable for the senior as the years pass. If the senior retains the home, upon his or her death, the home would be included in his or her estate and would receive a step-up in basis in the hands of his or her heirs. Internal Revenue Code section 1014.

The prospective purchaser-lessor's alternatives are alternative investments, either in single family residential property, other real estate, or a non-real estate investment. The simplest alternative is that the investor would purchase the senior citizen's home and rent it to a third party or parties. In this instance there is little doubt that the investor would receive the tax benefits of ownership of investment real estate. Another likely alternative investment is a syndicated real estate investment, once again generating real estate investment tax deductions for the investor.

Mr. Woodward's chief objection to S.1914 seems to be the "purchase price discount," which he argues is in fact prepaid rent to the purchaser-lessor and gain to the seller-lessee. The revised version of the bill strictly limits both the amount that the full fair market price of the property may be "discounted" and the extent to which a rent less than the full fair market rent for the property may be charged. Some limits on both of these are appropriate in order to prevent sham transactions and abuses of the sale-leaseback transaction. As limited by the revised bill, the extent to which either the price or the rent is "discounted" is minimal and is defensible under existing law.

The importance to the seller-lessee of some limitation on rent increases over the term of the lease is evident. Without a constrained rent, a seller-lessee could otherwise be forced out of the home at some point because of an unaffordable rent. However, an initial discount from fair market rent is not of great importance to the seller-lessee. The concern that originally generated the 80% of the appraised fair market rent standard in the original bill was the difficulty of determining appraised fair market rent in the single family dwelling rental market, where comparable rental properties are often difficult to find; the 80% was simply intended as a cushion against error.

The revised version of the bill provides that the rent must be a fair rental for the first year of the lease, but that that rental will not be considered to be less than a fair rental in any later year of the lease due to any constraints on rent increases imposed by the lease. This permits the lease to protect the seller from unlimited rent increases without sanctioning "sham" rents. (In fact, constraints on residential rent increases do reflect the market to the extent that they are imposed by local rent control ordinances, which are becoming increasingly prevalent.)

With regard to the "discount" from the full fair market price of the property, I submit that some "discount" is properly supported as other than prepaid rent in any event. The language of the revised bill permits a "discount" from the full fair market price of the property only to the extent that the "discount" reflects the leaseback condition and takes into account the terms of the lease. Mr. Woodward himself has recognized that some portion of a "discount" is properly attributable to factors other than a rental that is less than the full fair market rental. Some of these factors are intangible, but would have a real effect on the price that a willing buyer would pay a willing seller in an arm's length transaction. They include the delay between purchase and ultimate possession of the residence, the uncertainty in the length of the lease term, the uncertainty in the rental market, the benefits of having the senior citizen former owner of the property as a tenant, and other terms and conditions of the lease as negotiated.

Further, under Giberson v. Commissioner, 44 T.C.M. 154 (CCH) (1982), a discount from the full fair market price of the property unencumbered by a leaseback condition does not constitute prepaid rent. In Giberson, the Gibersons purchased a home from Mr. Giberson's ex-sister-in-law and leased it back to her for a period of five years at a rental rate that was lower than the fair market rent. The purchase price of the home was less than the fair market value of the home unencumbered by any leaseback condition. The issue presented, as defined by the Tax Court, was "whether [Gibersons] received additional income . . . when they purchased property under an agreement by which the consideration was substantially below fair market value but the property was leased back to the seller for a fixed term at a rent based on what the seller could afford."

The Commissioner argued that the transaction was a retained interest transaction; that is, that less than the entire fee had been conveyed and that the seller had retained a present possessory interest. The Court determined that a true sale-leaseback had taken place.

The Court then turned its attention to "the onerous task of valuing [Gibersons'] leased fee interest," and rejected the Commissioner's argument that the difference between the full fair market value of the property unencumbered by any leaseback condition and the price paid by the Gibersons constituted prepaid rent. The Court was willing, however, to examine whether Gibersons had paid less than the value of their "leased fee interest."

In so doing, the Court did not ascribe any value to the "discounted" rent, but approved the method of appraising the value of a leased fee interest described in The Appraisal of Real Estate, American Institute of Real Estate Appraisers (7th edition,1978) pps. 473-478. This approach consists of appraising the value of the reversion and adding to it the present worth of the contract rent under the lease. It is clear that using this approach, depending upon the rent that is in fact negotiated under the lease and other factors and assumptions used in the appraisal of the value of the reversion, a value less than the full fair market value of the property unencumbered by a lease would often result.

The Court rejected the Commissioner's reliance on Alstores Realty Corp. v. Commissioner, 46 T.C. 363 (1966), as controlling the facts. In Alstores, the case upon which Mr. Woodward also relies, the seller received a rent-free right of occupancy of a portion of the property sold for two and one-half years. Moreover, the seller treated an amount equal to the rental rate for other areas of the building as prepaid rent for the portion of the building that the seller occupied for the two and one-half year period. The Alstores case does not present a "discounted" rent fact situation, but the absence of any rent whatsoever; it also presents a situation in which at least one of the parties to the transaction had bargained for a prepaid rental as part of the consideration for the sale.

It is critical that the sale-leaseback home equity conversion rent be constrained to protect the senior seller. Even though some "discount" from the full fair market value of the property can be treated as other than prepaid rent under current law, the risk that the rental constraint will be deemed to account for some portion of the "discount" and thus constitute prepaid rent makes the inclusion of rental constraints in a sale-leaseback home equity conversion dangerous for the investor, and generates the need for the bill.

The remaining tax benefits to the purchaser-lessor (other than the use of ACRS) are clearly available under existing law in the type of transaction that the bill covers. Unless the position is taken that some of these benefits should be specifically withdrawn from these transactions but not from other real estate investments, which I believe is not a supportable position, there should be no rationale to oppose them.

Thank you for your attention to these comments.

II. REVISED BILL

S.1914

A BILL

To amend the Internal Revenue Code of 1954 to facilitate home equity conversions through sale-leaseback transactions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

That this Act may be cited as the "Home Equity Conversions Act of 1983".

SEC. 2. DEPRECIATION IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Section 167 of the Internal Revenue Code of 1954 (relating to depreciation) is amended by inserting after subsection (h) the following new subsection:

"(i) QUALIFIED SALE-LEASEBACK TRANSACTIONS. -

"(1) IN GENERAL. - In the case of property involved in a qualified sale-leaseback transaction, the purchaser-lessor shall be recognized as the absolute owner of the property, and the deduction ^ shall be allowed to the purchaser-lessor.

"(2) DEFINITIONS. - For purposes of this subsection -

"(A) QUALIFIED SALE-LEASEBACK. - The term 'qualified sale-leaseback' shall include a transaction in which -

"(i) the seller-lessee -

"(I) has attained the age of 55 before the date of such transaction,

"(II) sells property which during the 5-year period ending on the date of the transaction has been owned and used by such seller-lessee as the seller-lessee's principal residence for periods aggregating 3 years or more,

"(III) obtains occupancy rights in such property pursuant to a written lease requiring a fair rental, and

"(IV) receives no right to repurchase the property at a price less than the fair market price of the property unencumbered by any leaseback condition at the time the right is exercised, and

"(ii) the purchaser-lessor -

"(I) is a person,

"(II) is contractually responsible for the risks and burdens of ownership and receives the benefits of ownership (other than the seller-lessee's occupancy rights) after the date of such transaction, and

"(III) pays a purchase price for the property that is not less than the fair market price of the property encumbered by the leaseback condition, taking into account the terms of the lease.

"(B) OCCUPANCY RIGHTS. - The term 'occupancy rights' means the right to occupy the property for any period of time, including a period of time measured by the life of the seller-lessee (or the surviving seller-lessee, in the case of jointly-held occupancy rights) or a periodic term subject to a continuing right of renewal by the seller-lessee (or the surviving seller-lessee, in the case of jointly-held occupancy rights).

"(C) FAIR RENTAL. - For purposes of section (2)(A)(i)(III) above, a rental that is not less than a fair rental for the first year of the seller-lessee's occupancy rights shall be deemed to be a fair rental for any subsequent year of the seller-lessee's occupancy rights.

"(3) SAFE HARBOR. - The failure of a transaction to satisfy all of the terms and conditions of the definition set forth in section 167(i)(2) above shall not raise any presumption that the transaction is not a qualified sale-leaseback".

SEC. 3. CAPITAL GAINS EXCLUSION IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Subsection (d) of section 121 of the Internal Revenue Code of 1954 (relating to one-time exclusion of gain from sale of principal residence by individual who has attained age 55) is amended by adding at the end thereof the following new paragraph:

"(9) SALE OR EXCHANGE DEFINED. - For purposes of this section, the term 'sale or exchange' shall include a qualified sale-leaseback transaction as defined in section 167(i)."

SEC. 4. INCOME IN QUALIFIED SALE-LEASEBACK TRANSACTION.

(a) GROSS INCOME. - Part III of subchapter B of chapter 1 of subtitle A of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by inserting after section 121 the following new section:

"SEC. 121A. INCOME IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

"Gross income to the seller-lessee or the purchaser-lessor in a qualified sale-leaseback transaction as defined in section 167(i) does not include any value of occupancy rights or any discount from the fair market price of the property unencumbered by the leaseback condition attributable to the leaseback condition."

(b) GAIN OR LOSS. - Subsection (b) of section 1001 of such Code is amended -

(1) by striking out "and" at the end of paragraph (1),

(2) by striking out the period at the end of paragraph (2) and inserting in lieu thereof ", and", and

(3) by inserting after paragraph (2) the following new paragraph:

"(3) in the case of a qualified sale-leaseback transaction (as defined in section 167(i)) -

"(A) there shall not be taken into account any value of occupancy rights or any discount from the fair market price of the property unencumbered by the leaseback condition attributable to the leaseback condition, and

"(B) there shall be taken into account the cost of any annuity purchased for a seller-lessee by a purchaser-lessor.":

(c) CLERICAL AMENDMENT. - The table of sections for part III of subchapter B of chapter 1 of subtitle A of such Code is amended by inserting after the item relating to section 121 the following new item:

"Sec. 121A. Income in qualified sale-leaseback transactions."

SEC. 5. INSTALLMENT SALES IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Section 453 of the Internal Revenue Code of 1954 (relating to installment method) is amended -

(1) by redesignating subsection (j) as subsection (k), and

(2) by inserting after subsection (i) the following new subsection:

"(j) APPLICATION WITH SECTION 167(i). -

"(1) IN GENERAL. - In the case of an installment sale in a qualified sale-leaseback transaction (as defined in section 167(i)), subsection (a) shall apply.

"(2) SPECIAL RULE FOR ANNUITIES. - In the case of an annuity purchased for the seller-lessee by the purchaser-lessor in a qualified sale-leaseback transaction, the purchase cost of such annuity shall constitute the amount of consideration received by such seller-lessee attributable to such annuity and shall be deemed received in the year of disposition."

SEC. 6. BASIS OF ANNUITY RECEIVED IN QUALIFIED SALE-LEASEBACK TRANSACTION.

Subparagraph (A) of section 72(c)(1) of the Internal

Revenue Code of 1954 (relating to annuities) is amended by inserting before the comma "(including such amount paid by a purchaser-lessor in a qualified sale-leaseback transaction defined in section 167(i))".

SEC. 7. QUALIFIED SALE-LEASEBACK TRANSACTION ENGAGED IN FOR PROFIT.

(a) FOR PROFIT PRESUMPTION. - Section 183 of the Internal Revenue Code of 1954 (relating to activities not engaged in for profit) is amended -

(1) by striking out "If" in subsection (d) and inserting in lieu thereof "(1) IN GENERAL - If",

(2) by inserting after paragraph (1) of subsection (d) (as designated by paragraph (1)) the following new paragraph:

"(2) QUALIFIED SALE-LEASEBACK TRANSACTION. - Any qualified sale-leaseback transaction as defined in section 167(i), unless the Secretary establishes to the contrary, shall be presumed for purposes of this chapter to be an activity engaged in for profit.", and

"(3) by inserting "(1)" after "subsection (d)" each place it appears in subsection (e)."

(b) USE OF DWELLING UNIT. - Section 280A(d)(3) of such Code (relating to disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.) is amended by inserting after subparagraph (D) the following new subparagraph:

"(E) FAIR RENTAL IN A QUALIFIED SALE-LEASEBACK TRANSACTION. - In a qualified sale-leaseback transaction as defined in section 167(i), a rental that constitutes a fair rental pursuant to section 167(i)(2)(C) shall constitute a fair rental for purposes of subparagraph (A), but this subparagraph (E) shall not raise any presumption that any other rental does not constitute a fair rental for purposes of subparagraph (A)."

SEC. 8. ACCELERATED COST RECOVERY SYSTEM IN QUALIFIED SALE-LEASEBACK TRANSACTIONS.

Subparagraph (B) of section 168(e)(4) of the Internal Revenue Code of (1954) (relating to the accelerated cost recovery system) is amended by inserting after "December 31, 1980" and before the comma "(except property acquired by the taxpayer in a qualified sale-leaseback transaction as defined in section 167(i))".

SEC. 9. EFFECTIVE DATE.

The amendments made by this Act shall apply to sales after the date of the enactment of this Act, in taxable years ending after such date. Consideration or passage of this Act does not raise any presumption that sales prior to such date should not be treated as qualified sale-leaseback transactions as defined in Section 2 of this Act.

III. COMMENTS ON PROPOSED REVISIONS TO S.1914

S.1914 section 2; I.R.C. § 167(i)(1).

This revision clarifies that in a qualified sale-leaseback the purchaser-lessor becomes the owner of the property and eliminates the implication that less than a fee simple interest is sold.

S.1914 section 2; I.R.C. § 167(i)(2)(A)(i)(II).

The language of this section was changed to conform to the language of Internal Revenue Code section 121(a). Rather than introducing a new concept into the Code, it would be useful and appropriate to carry over the interpretations developed under section 121(a) here.

S.1914 section 2; I.R.C. § 167(i)(2)(A)(i)(III).

The phrase "obtains occupancy rights" was substituted for the phrase "retains occupancy rights" in this subsection once again to make clear the true sale-leaseback nature of the transaction and to eliminate the implication that a retained interest transaction is at issue.

S.1914 section 2; I.R.C. § 167(i)(2)(A)(i)(IV).

The added language prohibits the seller-lessee from receiving an option to repurchase the property at less than its full fair market value as part of the transaction. This should help to prevent sham transactions from taking place and conforms to one of the criteria applied to commercial sale-leasebacks to determine whether a true sale-leaseback has occurred.

S.1914 section 2; I.R.C. § 167(i)(2)(A)(ii)(II).

The language added here makes clear that the purchaser-lessor is to receive the benefits of ownership (other than the seller-lessee's occupancy rights) after the closing of the sale-leaseback. This also conforms to one of the criteria applied to commercial sale-leasebacks and should help to prevent sham transactions.

S.1914 section 2; I.R.C. § 167(i)(2)(A)(ii)(III).

This added subsection imposes a minimum price to be paid by the purchaser-lessor for the property. This language permits the price to be less than the full fair market price of the property unencumbered by a leaseback condition, but does not permit payment of a purchase price that is less than the fair market price of the property encumbered by the leaseback condition. (See discussion of this change in the preceding narrative.)

S.1914 section 2; I.R.C. § 167(i)(2)(B).

This new definition of occupancy rights is intended to permit the leaseback term to be tailored to the seller's needs. The requirement in the former language that the leaseback term terminate no later than the date of death of the seller-lessee or the seller-lessee's surviving spouse is not a necessary limitation. The only critical point that needs clarification here is that a lease term measured by the life of the seller-lessee will not result in the leaseback being treated as a life estate. Conversely, it would be a mistake to eliminate a lease term that terminated upon the seller-lessee's moving out of the property, at which time the sale-leaseback would have served its purpose. Some flexibility with the term is desirable.

S.1914 section 2; I.R.C. § 167(i)(2)(C).

The definition of fair rental has been changed to be more accurate by eliminating the concept of a "discount" from fair market rental. The current language would result in the rent being a full fair market rent for the first year of the lease term, but would permit the lease to provide that the rent either could not be increased at all or could be subject to very limited increases over the course of the lease term without being deemed other than a fair rental. This of course is one of the key provisions from the point of view of the seller-lessee. If the rental is a full fair market rental at the beginning of the lease term, the parties are then in a position to adjust the other terms of the transaction to insure that the seller-lessee will continue to have income available to pay that rental. If increases in rent are scheduled in a given instance, the seller-lessee will also be able to plan to meet those increases. However, this provision will protect the seller-lessee from the exposure that he or she would have if the rent were subject to unlimited increases over the term of the lease.

S.1914 section 2; I.R.C. §§ 167(i)(2)(A) and 167(i)(3).

The word "means" was changed to "shall include" in section 167(i)(2)(A) and subsection (3) was added to insure the safe-harbor nature of this legislation.

S.1914 section 4 -- Heading.

The words "to seller" in the heading were deleted to make clear that Internal Revenue Code section 121A provided for by this section of the bill will apply to both the seller-lessee and the purchaser-lessor.

S.1914 section 4; I.R.C. § 121A.

Both the heading and the language of this section have been revised to confirm that the section applies to both the seller-lessee and the purchaser-lessor. The change is consistent with the minimum purchase price limitation imposed by section 167(i)(2)(A)(ii)(II) as proposed by this version of the bill, and is necessary to prevent either party from being taxed on "phantom income." Under the Giberson rationale, discussed above, a discount from the full fair market price unencumbered by the leaseback condition would not necessarily now be treated as income to either party. Therefore, I believe that this section clarifies rather than changes existing law.

S.1914 section 4; I.R.C. § 1001(b) (3).

The language changes to subsections (A) and (B) conform the language to other revised sections of the bill.

S.1914 section 7; I.R.C. § 280A(d) (3).

In a true saleleaseback, the seller-lessee has no interest in the proprty other than his or her interest as a tenant, and it should therefore be unnecessary to include the seller-lessee under the special rules for a rental to a person having an interest in the unit provided for by existing Internal Revenue Code section 280A(d)(3)(B). After the closing of a sale-leaseback transaction, the seller-lessee will not have an equity interest in the property such as a tenant who is a party to a shared equity financing of the property. However, it is important that in a sale-leaseback home equity conversion fair rental be determined for purposes of section 280A(d)(3) in the same manner that it is determined for purposes of section 167(i)(2)(C) as proposed by the bill. New subsection (E) is intended to achieve this result.

S.1914 section 8; I.R.C. § 168(e)(4)(B).

This is a new proposed section of the bill that would include property acquired from and leased to a party who owned the property in 1980 in a qualified sale-leaseback transaction in the definition of recovery property for purposes of the accelerated cost recovery system. Section

168(e)(4)(B) presently provides that property acquired from and leased back to a person who owned the property in 1980 is excluded from the definition of recovery property; property that is not recovery property is not eligible for use of the accelerated cost recovery system.

Obviously, sale-leaseback home equity conversion would be attractive to certain elderly persons who owned and lived in their homes in 1980. To put these transactions on a par with a transaction in which an investor purchased the dwelling and rented it to a third party rather than renting it to the former senior citizen owner, language excepting sale-leaseback home equity conversions from this anti-churning provision is necessary.

Some persons are of the view that the existing anti-churning provision does not, in fact, apply to property that was nondepreciable property in the hands of the seller-lessee, and if that is indeed the case this added language is not necessary. However, I understand that the Service is taking the position that the anti-churning rules do apply to sale-leaseback home equity conversions.

S.1914 section 9; (former section 8).

Further safe harbor language has been added to this section.

IBAM SUPPORTS S.842

Statement for Record of October 28,1983 Hearing

Current tax laws and high interest rates place a heavy burden on small business. A small business should be described not so much as to the number of employees or its annual volume or assets, but as one that depends heavily upon internal sources of funds to finance growth and expansion. That is its own assets and those of its principal owners.

As a former small business owner who "boot strapped" for many years, it was not until I sold my business, a weekly newspaper, that I could cash in on my "sweat of the brow" investment I had in my business. With a low initial investment, a bank will only consider actual investment of dollars in a business even when one's "life investment" might be much higher and dearer than the cash investment. One is often faced with the choice of selling the business or losing control of it in order to get funds to expand it. One might add here that expansion means the creation of new jobs.

With this in mind, a new affordable source of growth capital is needed to help small business expand and purchase needed equipment. The Small Business Participating Debenture (SBPD) answers this need and opens up a new source of external capital which is crucial to the success of many small firms.

The SBPD offers many advantages to both the business owner and investor. Owners retain total ownership and control, while at the same time, get external capital at a rate they can afford. The small business owner is entitled to deduct as a business expense, both the basic interest payments and the share of earnings. The investor's SBPD interest is taxed as ordinary income, but their share of the firm's earnings would be taxed as a capital gain.

The Independent Business Association of Minnesota (IBAM) supports legislation creating the SBPD as a means of providing capital to small businesses without access to the equity capital markets. While this will be of great benefit and even assure survival of many small businesses and create many new jobs, it will be inexpensive to administer since there is no government involvement required. There is also no risk of loss to the government.

As to how this will effect government revenues, the first tax element, stated interest, involves no change from the present law and would have no effect. The second feature would create a deduction to the borrower and capital gain to the lender. This is a change from current law and thereby reduces the income taxable to the lender and would reduce tax revenues.

However offsetting these tax revenue losses will be: taxes on additional profits generated by the small business, taxes on wages paid to new employees through the jobs created by the expansion of the small business. And taxes on profits generated by suppliers of materials and services purchased by the small business to expand.

In the long run this should be looked at as a jobs creation and revenue base expansion bill that will increase governmental revenue.

IBAM supports S.842 and urges its passage.

John A. Herman
President, IBAM

AN ESTIMATE OF SMALL BUSINESS FINANCING NEEDS TO COMPLY WITH EPA REGULATIONS

by

ICF Incorporated

for

Marc Jones
EPA Small Business Ombudsman

September 7, 1983

CHAPTER I

INTRODUCTION

This report provides a crude estimate of the total financing needs of small business to comply with recently promulgated and soon-to-be promulgated Environmental Protection Agency regulations. The fundamental source of data for this study was the economic impact analyses prepared to support various Environmental Protection Agency Effluent Limitations and Standards based on Best Available Technology (BAT) and Pretreatment Standards for Existing Sources (PSES), New Source Performance Standards for air discharges from stationary sources, and Land Disposal Regulations. The primary variable used to measure the potential financing needs of the small businesses in the industries evaluated was capital investment costs.

1. Report Organization

After this introductory chapter, the methodology employed is explained in Chapter II. Chapter III summarizes the data derived in Appendices A, B, and C which detail the estimates of the capital investment small businesses would need to comply with selected EPA regulations. External funds are defined as funds acquired through borrowing (debt) or by selling new stock or investing personal funds of the owners (equity). Finally, in Chapter III adjustments are made to the capital investment requirements developed in Appendices A through C to provide a "rough-cut" estimate of the total financing needs of small business associated with both recently promulgated EPA regulations and with forthcoming EPA regulations.

Appendix A presents the results of previous economic impact studies of the proposed, or finalized, effluent guidelines on eight industries which were known to have many small participants and significant costs of compliance. Small businesses were defined variously for each of the industries. Where the definition was unclear, combinations of two or more definitions of small business were used to determine compliance costs.

Appendix B presents the economic impacts on small entities resulting from compliance with the Part 264 land disposal regulations. Unfortunately, the docket report dealing with these regulations (dated August 24, 1982) did not estimate small business compliance costs. Rather, it estimated the cost per site without distinguishing between large and small businesses. The report did distinguish between small and large plume sizes for four types of land disposal processes affected by the Part 264 regulations: landfills, surface impoundments, land treatment areas, and waste piles. ICF based the small business capital needs estimate on small plume size cost estimates and reviewed the impact of these regulations on selected industries.

Appendix C analyzes four industries with a relatively high concentration of small businesses affected by New Source Performance Standards (NSPS). Small businesses were defined variously for each of these industries. It was especially difficult to estimate compliance costs for the asphalt roofing manufacturing industry and the perchloroethylene dry cleaning industry at the small business level, because the Agency's study did not specify what a small business was or how many were affected by these two regulations. Chapter III-3 describes this matter in detail.

2. Summary of Findings

This first-cut analysis indicates that at least $240 million and possibly much more will have to be obtained by small business from the capital markets to finance compliance with EPA's effluent guidelines, NSPS, RCRA regulations presently under development or recently promulgated.

This particular estimate should not be construed as anything more than a first-cut indication of the likely external financing needs. There are a number of reasons for this qualification. First, the scope of the effort in estimating these requirements was quite limited, initially structured to be only a compilation of existing data. Unfortunately, very few economic impact studies included small business effect analyses, thus requiring ICF to develop the rough estimates as discussed in this report. Second, only to the extent that the average capital costs to small business for the regulations reviewed in this analysis are comparable to those across all regulations, can the estimates be reasonably extended to the impact of future regulations. Third, in several instances lack of data required heroic assumptions to be made about the universe of affected small business. Thus, the findings presented in this analysis should be interpreted carefully and only used in the limited context of initially identifying the potential relative impact of upcoming EPA regulations on small businesses.

National Association of Home Builders
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FOR IMMEDIATE RELEASE

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BILL TO EXPAND USE OF MORTGAGE-BACKED ENDORSED BY THE NATION'S HOME BUILDERS

WASHINGTON, Nov. 4 -- The National Association of Home Builders has thrown its support behind proposed legislation that would eliminate the second class status of mortgage-backed securities and increase by billions of dollars the amount of affordable mortgage credit available for consumers shopping for homes.

The legislation (S. 1822), called Trusts for Investments in Mortgages (TIMs), is being considered by the Senate Finance Committee and is co-sponsored by Sen. Jake Garn (R-Utah) and Sen. John Tower (R-Texas).

Testifying today before the Finance Committee, NAHB President Harry Pryde said that the TIMs legislation would "strengthen and enhance" the secondary mortgage market which has become the cornerstone of the nation's mortgage finance system. "By 1990," he added, "between two-thirds and three-fourths of all mortgages originated will be passed through to the secondary mortgage market, and the total demand for mortgages during the remainder of this decade is estimated at $1.6 trillion."

"The American dream of owning a home is dependent, to a great extent, on the availability of affordable mortgage credit," he said. "This legislation would give home buyers a chance to compete in the capital markets for affordable financing."

-more-

The legislation would eliminate regulatory, legal and tax obstacles currently inhibiting the use of "mortgage-backed securities," a term used to describe pools of hundreds of thousands of dollars of mortgage loans that are packaged into bond-like securities and sold to investors.

The Garn-Tower bill would "eliminate the second class status of mortgage-backed securities" and make them competitive to corporate bond obligations and other investments, Pryde said. Furthermore, the legislation would make mortgage-backed securities attractive to all types of investors, including pension funds, insurance companies, financing institutions and individuals.

Pryde urged the Committee to amend the proposed bill to allow the two major secondary market institutions, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, to establish TIMs. "This would provide additional mortgage funds at lower interest rates for the average home buyer," he said.

Under the proposed bill, Fannie Mae and Freddie Mac are prohibited from setting up TIMs.

# # # #

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Oct 28

NASBIC
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
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*EXECUTIVE COMMITTEE

November 15, 1983

Senator Bob Packwood, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
SD-219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Packwood:

The National Association of Small Business Investment Companies (NASBIC) is pleased to submit this statement in conjunction with your Subcommittee's October 28, 1983 hearings on S. 842. We appreciate the extension of time granted to submit our statement.

At the outset, we wish to commend you and the members of your Subcommittee for the initiative you've undertaken to hold hearings on a subject of critical importance to the small business community of this nation. Congressional action to create a so-called "small business participating debenture" has been a top priority of the small business community for several years, and your Subcommittee's hearings represent a significant step forward in that process.

NASBIC and SBICs

As the national trade association for our industry, NASBIC represents the vast majority of all licensed small business investment companies (SBICs) and minority enterprise small business investment companies (MESBICs). SBICs provide equity capital, long-term loans and management assistance to small business concerns. As a significant element of the venture capital industry, SBICs are privately-owned and managed and their investment transactions with small firms are freely negotiated in the commercial marketplace. At the same time, all SBICs are licensed and regulated by the Small Business Administration.

The Shortage of Capital for Small Business

The basic point we want to make in this statement is that the creation of a new form of security like the participating debenture envisioned by S. 842 will provide virtually hundreds of thousands of small firms access to capital resources that are not available to them today.

Small companies have traditionally experienced difficulty in attracting captial from both institutional and individual investors. The level of institutional aggregation of capital has grown to the point where insurance companies, pension funds, money market funds and bank trust funds clearly dominate our securities markets. Yet, these investors concentrate their investments in large companies, avoiding small business investment opportunities. The conventional reasons for institutional investor avoidance of small business are related to structural economies of scale, regulatory restrictions which make these investments unacceptable in the institutional marketplace, disproportionate risk compared to anticipated return and the lack of liquidity for small business securities. Individual investors have limited their investments in small firms for many of the same reasons.

At the same time, small businesses are finding it increasingly more difficult to obtain conventional debt capital from commercial banks which have been their traditional source of funds. As a result of high default and bankruptcy rates in the small business sector of the economy, combined with reduced rates of bank profitability, commercial banks have assumed a posture of risk aversion and more stringent credit practices. The result has been a drop in the rate of small business loans compared to a dramatic increase in the rate of loans to big business. Even when bank loans are available to small firms the so-called risk premium that small business must pay is usually quite substantial.

The one bright light in field of small business financing has been the venture capital industry, which includes both SBICs and privately-managed venture funds. The growth of the venture capital industry in the past five years, from less than $3 billion in resources in 1977 to its present level of some $10 billion has been dramatic, but the industry is still a very tiny segment of the U.S. capital markets. By comparison, pension funds alone have total assets in excess of $850 billion.

The SBIC industry is celebrating its 25th Anniversary this year, and we are proud of the job we're doing to help the nation's growth-oriented small businesses. Over those 25 years, SBICs have invested more than $4 billion of equity capital and long-term venture loans in over 60,000 small business concerns.

Since 1978, the investment activity level of venture investments in small firms has increased dramatically as entrepreneurs recognized that investment capital was available and entered the market, creating a healthy flow of new investment opportunities. Today, venture firms are investing at record levels in the range of $2 billion annually.

Today, over 360 SBICs, with assets of more than $2 billion, are actively engaged in the financing of emerging growth companies. During 1983, SBICs have invested in small firms at a rate of over $400 million per year, which is the highest investment level in the history of the program.

However, there are also inherent limitations on the venture capital industry's ability to meet the expanded capital needs of small business. First, there is the basic limitation on the amount of resources available and committed to the venture industry as compared with the continuing, multi-billion dollar financial needs of the small business community. Second is the venture investor's need to achieve high incremental investment returns from investment opportunities with substantial growth prospects, necessary to compensate for the high degree of risk involved in venture investing; coupled with a need for liquidity or exit opportunity so the venture capitalist can realize on appreciated values. Realistically, these basic characteristics can only be met by a relatively small segment of the 10 million small business firms in this country. Finally, there is an aversion to seeking venture investment by some small businessmen because it may involve the granting of voting or equity interests in their companies.

As a result of these limitations, a substantial number of small and medium sized businesses with moderate growth potential still face severe capital gap conditions. While many SBICs provide debt and equity-type capital to small firms that lack exceptional growth potential or ultimate stock market liquidity, the vast majority of these companies are starving for both initial and expansion capital. While these businesses may not be the superstars of tomorrow, they often provide important economic and social benefits in terms of aggregate impact on their local economies. Many of these firms are small, often mundane businesses that achieve moderate success. As such, they have the capacity to earn profits, to provide jobs and to service long-term debt; as opposed to the typical short-term commercial bank financing which may be available to them at high rates of interest.

S. 842 and "Small Business Participating Debentures"

The need, therefore, is for a special type of investment instrument which will attract both individual investors as well as conventional sources of investment capital to invest in these moderate-growth small firms. The proposed "Small Business Participating Debenture" (SBPD) in S. 842 provides exactly the kind of security which will do that job. The proposed capital gains tax treatment of the investor's earnings participation from SBPDs will make these securities substantially more attractive to investors from their perspective of a necessary rate of return-on-investment; while the fixed maturity addresses the liquidity issue by providing a fixed date for a recapture of the investor's principle.

The advantages to the small firm are also substantial. Its ability to deduct the earnings participation provided the investor, as well as the interest payments, as business deductions make the SBPD a very attractive instrument for the small firm from a tax perspective. At the same time, the small business is left in the positive position of being able to negotiate a favorable rate of interest on the debt portion of the security; while not having to negotiate over an interest in or control of the company.

In summary, we firmly believe the passage of S. 842 would substantially broaden the range of small companies for which both individual and institutional investors would provide financing. As a concrete example, when SBPDs were discussed at a recent meeting of our Board of Governors, the majority of our Governors indicated the new security would enable their SBICs to finance many additional small firms which would not have been otherwise eligible. We believe this same result would occur with other institutional and individual investors and, consequently, we are convinced that S. 842 would make significant flows of capital available to hundreds of thousands of deserving small firms which are now effectively excluded from the capital markets.

We understand that one major concern with the proposed SBPDs is the potential revenue impact they may have. On this point, we support the conclusions reached by Edward Pendergast in his testimony before the Committee to the effect that implementation of S. 842 will generate significant increased revenues to the U.S. Treasury, as well as provide increased job opportunities. By way of analogy, we would point out that economic impact studies of the SBIC program show that SBIC-financed small firms experience growth rates almost 10 times as great as those of other small companies in such key areas as sales, profits and employment. These studies also show that the growth of Federal tax payments by SBIC portfolio companies is 5 times that of all other small concerns. We believe a similar result will occur with the passage of S. 842, by providing incentives to large numbers of sophisticated institutional investors and individuals to invest in thousands of moderate-growth small firms.

We strongly support the passage of S. 842.

Sincerely,

Peter F. McNeish
Executive Vice President

Supplemental Statement on S. 1914

Submitted to the Senate Finance Committee
Subcommittee on Taxation and Debt Management
by Ken Scholen, Director
National Center for Home Equity Conversion
Madison, Wisconsin
November 10, 1983

This statement discusses issues raised by the Treasury Department as they relate to a revised version of S. 1914 submitted to the Subcommittee by Trudy Ernst.

The Ernst draft is the result of a mark-up process involving Ms. Ernst and other interested parties including myself. This new draft more accurately reflects the sale leaseback transactions that have been developed and offered in various parts of the country. It strengthens the bill from a consumer's perspective, and it responds to tax policy concerns voiced by the Treasury Department.

This discussion of the Ernst draft is keyed to the statement delivered by Robert G. Woodward, Tax Legislative Counsel, Department of the Treasury before the Senate Finance Subcommittee on Taxation and Debt Management on October 28, 1983.

In that statement, Mr. Woodward characterized the central problem addressed by S. 1914 as follows:

1) the tax consequences of "traditional" sale leasebacks are clear; but
2) such transactions are "not advisable for many homeowners because of the absence of suitable protection for the seller-lessee"; therefore
3) "an alternative plan has been proposed by several promoters"; and
4) S. 1914 establishes a safe harbor for this alternative plan.

The first two items in this characterization are accurate; the rest is not accurate.

In fact, no developer or promoter has proposed the alternative plan described in the Treasury statement. Specifically, no plan has been proposed in which "the required rental payment would be up to 20 percent below the fair market rent in the year of the sale."

It is true that S. 1914 statutorily permits this below-market rent. However, that provision 1) was not based on any existing or proposed plan; 2) is neither a necessary nor an advisable element of the bill; and 3) does not appear in the Ernst revision.

In fact, the 20% statutory discount reflected a good-faith but mistaken effort to provide an administrative mechanism for determining "fair rental." It does not belong and is not needed in the statutory definition of a safe harbor for residential sale leasebacks. No "alternative" plan being developed or offered includes a below-market rent. Such a discounted rent is not needed to protect the occupancy rights of the seller-lessee.

The Ernst revision reflects existing and proposed sale leaseback plans that safeguard the seller. These plans include a fair market rent at the outset of the sale leaseback transaction. But they permit the buyer and seller to negotiate a schedule of future increases or a constraint on future increases in that fair market rent. In addition, they permit the parties to agree to a renewable or lifetime lease term. The Ernst revision also specifies that the buyer pays a purchase price not less than the fair market price of the property encumbered by the leaseback condition, taking into account the terms or the lease.

These new and revised provisions on rent, lease term, and purchase price clarify the degree to which a seller's occupancy rights can be safeguarded without jeopardizing the tax status of the transaction. They also respond to the Treasury Department's tax policy concerns.

In particular, Mr. Woodward's testimony focused on the tax exemption impact of S. 1914. However, it overstated the significance of that impact based on an incomplete reading of current case law. The Ernst revision further reduces and virtually eliminates this exemption factor.

Specifically, the Treasury testimony cited the Alstores decision (46 T.C. 363, 1966) in asserting that under current law the purchase price discount would be taxable income to the buyer as prepaid rent. That citation and assertion, however, were explicitly rejected in the subsequent Giberson decision (44 T.C.M. 39, 1982). The court 1) rejected the commissioner's contention that a leased fee interest in a residential sale leaseback "should be measured by the difference between the fair market value of the property . . . and the purchase price"; 2) rejected the commissioner's characterization of this value as "prepaid rent"; and 3) stated that the commissioner had "erroneously relied on the [valuation] method employed in Alstores . . . , in a factual context at odds with . . . " a residential sale leaseback involving contract rent as part of the purchase agreement.

The court did identify the specific valuation method appropriate for such cases, however. And, when that approved method is applied to sale leaseback transactions covered by the Ernst revision, the result is either a) no tax liability, or b) a substantially lower tax liability than the Treasury testimony suggests.

In other words, the "discount" is not the measure of any income to the buyer under current law. The proper valuation of a leased fee interest will in some cases indicate taxable income and in other cases indicate no taxable income. In sale leasebacks covered by the Ernst revision, there is likely to be little if any taxable income under current law. The Ernst revision completely eliminates or substantially reduces the exemption element in S. 1914 depending upon the precise details of the transaction.

That being the case, it makes sense from the standpoints of tax simplicity and administrative efficiency to draw the line of income exclusion in conjunction with this revised safe harbor definition. This would provide an approximate rather than a precise measurement device. But it would be more accessible and much easier to understand and administer than a complex, court-approved valuation process that 1) was apparently not even known to the Treasury's Tax Legislative Counsel, and 2) would produce little if any greater revenue.

In any case, it is an illusion to project even a minor revenue impact based on the degree to which the possibility of any tax exemption for some cases may remain in the Ernst revision. If this bill does not become law, then the transactions for which it provides a safe harbor are very unlikely to occur. Therefore any tax revenue based on leased fee interests in such transactions is very unlikely to materialize. Simply put, this legislation will not cause the loss of revenue through tax exemption that would otherwise be realized.

On the contrary, the Ernst version will produce new, taxable interest income to seller-lessees that otherwise would not materialize. And it will also enable older homeowners to choose to use their own private resources to meet their own retirement income needs.

The Department agrees that the tax status of sale leasebacks that don't safeguard the seller are clear; whereas the tax status of sale leasebacks that do safeguard the seller are not clear. This creates an unnecessary and pernicious tax incentive to shortchange the security of the elderly seller's occupancy rights.

The Ernst revision provides a sound solution to this problem. It 1) covers existing and proposed plans in a non-exclusive manner, 2) safeguards the seller's occupancy rights, 3) virtually eliminates any tax exemption impact, and 4) facilitates new, taxable income and greater self-sufficiency and independence for the elderly.

STATEMENT OF WILLIAM D. EVANS

PRESIDENT, XTRA CORPORATION

IN SUPPORT OF S.1231

BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
U.S. SENATE

October 28, 1983

I appreciate the opportunity to submit this statement on behalf of Xtra Corporation in support of S.1231. S.1231 would amend section 4063 of the Internal Revenue Code to provide the same exemption for piggyback trailers from the excise tax imposed by section 4051 of the Code as is presently afforded RoadRailer trailers.

THE COMPANY

Xtra, whose management offices are located in Boston, Massachusetts, is engaged through subsidiaries in the transportation service business. Its primary transportation service business is the leasing, on an operating basis, of piggyback trailers, containers, chassis, and railroad rolling stock. Xtra also operates an interstate motor common carrier of general and special commodities through its subsidiary, Mercury Motor Express, Inc., headquartered in Tampa, Florida. Xtra is also engaged in other transportation related activities, including repair of transportation equipment, public warehousing, shippers' agent activities, and the manufacture of specialized logging equipment. Xtra's leasing and other transportation activities require it to maintain storage, distribution, maintenance, manufacturing, regional offices and other facilities throughout the United States, including important facilities in Chicago, the St. Louis area, Newark and Atlanta.

Xtra's piggyback trailer fleet consists of approximately 29,000 units, making it one of the nation's leading lessors of piggyback trailers. Xtra's piggyback equipment is leased primarily to railroads in the United States.

USE AND DESIGN OF PIGGYBACK TRAILERS

Piggyback trailers are designed to enable freight to be moved long distances in trailers on railroad flatcars rather than in boxcars. Railroads are the users of piggyback trailers. Piggybacks are used on local highways and streets for short-distance pickup and delivery between the origination or destination point and the rail terminal. Piggybacks enable freight to be moved more efficiently by decreasing handling requirements that would otherwise be necessary in loading and unloading boxcars. Thus, the function of a piggyback is to transport freight for long distances on railroad flatcars and for short distances between the railroad terminal and the point of local origination or destination. A piggyback trailer spends most of its time in the transportation of freight by rail on railroad flatcars and not on the nation's highways.

Consistent with the piggyback's function for use on railroad flatcars, it is also physically designed for use principally in connection with railroad flatcar service. Significant and costly modifications are required by the Association of American Railroads to obtain piggyback certification. Unlike an over-the-road trailer, a certified piggyback trailer will have lift pads, a stanchion plate, extra heavy-duty locking bars, extra door thickness, extra heavy-duty construction with recessed fittings, heavy-duty side posts, heavy-duty support members, and special suspension assembly. The additional components and equipment required for a certified piggyback trailer result in a piggyback being more than 1100 pounds heavier and about $1,000 more costly than an over-the-road trailer.

PIGGYBACK TRAILERS SHOULD BE EXEMPT FROM THE RETAIL EXCISE TAX ON THE SALE OF TRUCKS AND TRUCK PARTS

Legislative History of Code Section 4051

Section 4051 of the Internal Revenue Code was enacted as part of the Highway Revenue Act of 1982 and converted the prior law 10 percent manufacturers excise tax on trucks to a 12 percent retail tax, effective April 1, 1983. The Ways and Means Committee Report on the bill ultimately enacted as the Highway Revenue Act of 1982 states as reasons for restructuring the tax the following:

> "In light of testimony presented before the committee to the effect that the costs of future highway improvements would be unfairly distributed if the current manufacturers excise tax on trucks were not modified, the committee believes that this tax should be restructured to yield no tax or a lower tax for lighter vehicles and a higher tax for heavier vehicles." H.Rept. No. 97-945, 97th Cong., 2d Sess., p.14.

Consistent with the Congressional purpose of restructuring and shifting the burden of the excise tax to heavier users of the nation's highways, the weight threshold for imposition of the tax was increased from 10,000 pounds to 33,000 pounds for trucks and to 26,000 pounds for trailers, and RoadRailer trailers were exempted from the tax.

Similarity of RoadRailer Trailers and Piggybacks Trailers

RoadRailer trailers and piggyback trailers are identical in function and use. Both are used primarily to carry freight on long hauls over rail and for short distances between the rail terminal and local point of origination or destination over local streets and highways. They are also very similar in physical design except that a RoadRailer trailer is equipped with rail wheels and highway wheels.

Fairness and Logic Require Identical Tax Treatment For Piggyback Trailer and RoadRailer Trailer

Taxpayers rightfully expect our nation's tax laws to be structured with a reasonable degree of fairness and consistency. The exemption of RoadRailer trailers from the excise tax on heavy trucks is indeed consistent with the reasons for the recent restructuring of the tax. For these very same reasons, piggyback trailers should also be exempt from the tax. RoadRailer and piggyback trailers are functionally and operationally identical, and neither should be subject to special taxes to pay for maintenance of highways they do not use, any more than trucks and over-the-road trailers should be required to pay for maintenance of the nation's rail system. The fact that a RoadRailer trailer is specially equipped to ride the rails directly, while a piggyback trailer is specially equipped to ride a railroad flatcar, is a distinction without relevance for purposes of a highway tax. The relevant factor is that both are primarily designed for and used in rail transportation and not in highway transportation.

It has been suggested that because RoadRailer trailers are heavier and more expensive to equip than piggyback trailers, they are less likely to be used as over-the-road trailers. The simple facts are that piggyback trailers and RoadRailer trailers have equivalent road use and both are used for only limited highway travel. Moreover, the proper issue is not the cost and weight of a piggyback trailer in relation to a RoadRailer trailer, but its additional design cost and operational cost for highway use in relation to the excise tax. Being in both the piggyback leasing and trucking business, we can categorically state that the additional design costs, together with the additional operational costs for highway use attributable to the added weight, would make it economically unsound and foolish to acquire a piggyback trailer for over-the-road service in order to avoid the excise tax.

CONCLUSION

S.1231 would remove the unwarranted distinction that currently exists between RoadRailer and piggyback trailers. Consistent with the Congressional purpose in restructuring the excise tax on the sale of heavy trucks, both piggyback and RoadRailer trailers should be exempt from the tax because both are principally designed for, and in fact principally used in, rail transportation. Piggyback trailers, like RoadRailer trailers, have only limited highway use. We urge the prompt enactment of S.1231.